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TAX REFORM PROPOSALS—VIII

HEARING

BEFORE THE

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UNITED STATES SENATE

NINETY-NINTH CONGRESS

FIRST SESSION

JUNE 25, 1985

(Debate on Industrial Development Bonds)

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CONTENTS

Public Witnesses

Page
Brookings Institution, Dr. Harvey Galper, senior fellow ... 66
Council of Industrial Development Bond Issuers, James J. Hughes, Jr., president ... 57
D'Amato, Hon. Alfonse M., a U.S. Senator from New York ... 42
Domenici, Hon. Pete V., a U.S. Senator from New Mexico ... 7
Galper, Dr. Harvey, senior fellow, The Brookings Institution ... 66
Giglio, Joseph, chairman, Private Sector Advisory Panel on Infrastructure Financing ... 9
Hufbauer, Dr. Gary C., counsel, Rose, Schmidt, Chapman, Duff & Hasley ... 83
Hughes, James J., Jr., president, Council of Industrial Development Bond Issuers ... 57
Hodgson, Russ, Andrews & Goodyear, Donald C. Lubick, partner ... 110
Kutak, Rock & Campbell, Lindsey Miller-Lerman, partner ... 116
Lubick, Donald C., partner, Hodgson, Russ, Andrews & Goodyear ... 110
Miller-Lerman, Lindsey, partner, Kutak, Rock & Campbell ... 116
Minarik, Dr. Joseph J., senior research associate, The Urban Institute ... 49
Rose, Schmit, Chapman, Duff & Hasley, Dr. Gary C. Hufbauer, counsel ... 83
Stennis, Hon. John C., a U.S. Senator from Mississippi ... 2
Urban Institute, Dr. Joseph J. Minarik, senior research associate ... 49

Additional Information

Committee press release ... 1
Prepared statement of Senator Frank Murkowski ... 1
Prepared statement of Senator John C. Stennis ... 5
Prepared statement of Senator Pete V. Domenici ... 10
Prepared statement of Joseph M. Giglio ... 11
A report by the Private Sector Advisory Panel on Infrastructure Financing ... 14
Prepared statement of Senator Alfonse M. D'Amato ... 44
Prepared statement of Dr. Joseph J. Minarik ... 52
Prepared statement of James J. Hughes, Jr ... 59
Prepared statement of Dr. Harvey Galper ... 68
Prepared statement of Gary C. Hufbauer ... 85
Prepared statement of Donald C. Lubick ... 112
Prepared statement of Lindsey Miller-Lerman ... 118

Communications

Cregg, George W., Sr ... 130
Ture, Norman B ... 132
Illinois Farm Development Authority ... 144
Mississippi Board of Economic Development ... 166
Nassau and Suffolk Counties for Industrial Development Agencies ... 167
Philadelphia Industrial Development Corporation ... 192
George C. Wallace, Governor of Alabama ... 201
Western Governors' Association ... 209
Letter to Hon. James Baker ... 211

TAX REFORM PROPOSALS—VIII

TUESDAY, JUNE 25, 1985

U.S. SENATE,
COMMITTEE ON FINANCE,
Washington, DC.

The committee met, pursuant to notice, at 9:26 a.m., in room SD-215, Dirksen Senate Office Building, the Honorable Bob Packwood (chairman) presiding.

Present: Senators Packwood, Chafee, Heinz, Durenberger, Symms, Grassley, Long, Bentsen, Moynihan, Bradley, Mitchell, and Pryor.

Also present: Senators Stennis, Domenici, and D'Amato.

[The press release announcing the hearing and the statement of Senator Murkowski follows:]

[Press Release]

CHAIRMAN PACKWOOD ANNOUNCED FINANCE TAX REFORM HEARINGS

Senator Bob Packwood (R-Oregon), Chairman of the Committee on Finance, today announced further Committee hearings in June on President Reagan's tax reform proposal.

Chairman Packwood announced the second five days of hearings, as follows:

On Wednesday, June 19, 1985, the Committee will receive testimony from witnesses representing taxpayer organizations and public interest groups.

The Committee will hear from public witnesses on the impact of the tax reform proposal on capital formation on Thursday, June 20, 1985.

On Tuesday, June 25, 1985, invited witnesses will discuss the issue of whether the tax-exempt use of industrial development bonds ought to continue.

On Wednesday, June 26, 1985, public witnesses will testify on research and development tax credits, and venture capital formation.

The Committee will receive testimony from economists on the impact of the President's tax reform proposal on the economy on Thursday, June 27, 1985.

All hearings will begin at 9:30 a.m. and will be held in Room SD-215 of the Dirksen Senate Office Building.

STATEMENT OF SENATOR FRANK MURKOWSKI

Mr. Chairman, I appreciate the opportunity to appear before the Finance Committee to express my views on the need to maintain the tax exemption of interest on state and local obligations.

I understand that this Committee plans to hold more hearings on this issue, and you do not expect lengthy statements to be made today on this complex subject. I will therefore keep my remarks short.

The continued use of tax exempt bonds is vital to the State of Alaska. Because Alaska is a new state with a small population, it is still developing its basic infrastructure and must take advantage of every means possible in this development effort.

Two state programs issuing tax exempt bonds deserve special attention. The first program is the Alaska Housing Finance Corporation's Veterans Mortgage Program which was created in order for veterans to acquire family home mortgages with interest rates lower than conventional loans. The other program provides the bulk of the small issue industrial development bonds that have been so successful in stimulating commercial growth and jobs in Alaska.

Regarding the Alaska Veterans Mortgage Program, as Chairman of the Senate Veterans' Affairs Committee I know the commitment and assurances our country has made to the veterans. Part of this commitment is to assist veterans' to purchase homes. One of the underlying reasons for this program is to compensate for the time lost while the veterans are serving this country rather than being employed in more lucrative jobs in the private sector.

Since 1982, the Alaska veteran home loan program has enabled 6,856 veterans to receive a special mortgage rate (between 8.5% and 10.5%) well below the market rate for a conventional home loan. So far this year, veteran loans have made up about 40 percent of all the Alaska Housing Finance Corporation's loans.

The tax exempt bonds that made this program possible may cost the government money in lost tax revenue. But this assertion misses the real issue—this progam was created to fulfill a social obligation, not to make money. Programs like the Alaska Veterans Mortgage Program should be encouraged not hindered.

As I already mentioned, I also strongly support the continued availability of tax exempt small issue industrial development bonds for commercial development and expansion.

The Alaska Industrial Development Authority (AIDA) facilitates the financing of industrial, manufacturing and business enterprises. During the past two years, AIDA has helped to finance approximately $370 million worth of investment for 257 projects which have created or retained an estimated 6,000 jobs. The Treasury proposes that these projects—termed private purpose projects by the Treasury—should not longer be financed through tax exempt bonds. Realistically, tax exempt bonds may be the only feasible way to finance these projects.

For instance, AIDA issued a $875,000 bond to finance the construction of a commercial facility built by the Kikiktagruk (kik/ē/ta/gruk) Inupiat Corporation (KIC) in Kotzebue, Alaska. The facility includes a grocery store, clothing and dry-goods store, hardware and parts store and bulk fuel supply.

Kotzebue is a small town but it is also a commercial center in Northwest Alaska. With a population of only 4,000 people, Kotzebue could not attract the funds for the KIC project without the help of industrial development bonds.

Mr. Chairman this is only one example of hundreds of private purpose projects built by tax exempt bonds. These private purpose projects are vital to Alaska's economy and welfare. For this reason and for the housing financed by the veteran mortagage bonds I urge the Senate Finance Committee to maintain the tax exemption of interest on state and local obligations.

The CHAIRMAN. The committee will come to order. The distinguished senior Senator from Mississippi is with us now. Because we have three other Senators that are going to testify, I think we will start just a few moments early.

Senator Stennis has been a long, longstanding champion of the small denomination industrial development bonds, he has fought for it hard and successfully in past years, and there is no one who is better able to testify in support of that position than our distinguished colleague Senator Stennis.

STATEMENT BY HON. JOHN C. STENNIS, A U.S. SENATOR FROM THE STATE OF MISSISSIPPI

Senator STENNIS. Thank you, Mr. Chairman. It is a privilege to be here with you and your committee. From what I have picked up with others, I am really pleased with the way you are getting along with your continuous hearings as chairman of this important committee.

Now, Mr. Chairman, this broad field, as you know, is a complicated field. But I want to point my testimony toward one segment, and that's the little fellow. That's what I've got my mind on, and there are several reasons for that. That's where I live. I know the problems there, the transitions.

I have a figure here, for instance. My home county used to grow, according to the census record, 17,000 I believe it is bales of cotton a year, and there is not a gin in the county now. That's a clean sweep; they virtually grow none. That shows one of the changes.

Now, going way back in the 1930's, the year of the Great Depression, a retired businessman in Mississippi ran for Governor on the ticket of getting together a community and organizing it and issuing a small amount of bonds in order to build a little plant of some kind that would induce someone to come and operate it and create some jobs—create jobs.

Now, I understand the arguments made to you that, well, that's a fallacy, that it doesn't create any jobs, and the jobs that are promoted would have come somewhere else or sometime, or something of that nature. But let's get back down to the ground level and think of people that have to live. It's people we are dealing with, not theories, and people who will have to solve their problems, not theoreticians. I speak with all deference to anyone who is trying to help you solve it.

I know what happened there in my State. It was the salvation of hundreds of communities to issue a small amount of bonds. The attractive feature of them was that the interest on them would be tax free; that was the only thing that gave added inducement.

The bonds sold, and they have been paid. I don't think there is a single one of them in default in the whole State. And as I say, I have known these people, know them by their first name, a lot of them. You can't just tell a fellow like that, "Well, go somewhere else and find you a job." I understand that was the advice of someone, proposing to just abolish the whole thing lock, stock, and barrel. And that's not Americanism, just to tell a worthy, law-abiding citizen, "Well, get up and get out. You look for a place somewhere." The whole concept is contrary to our values.

I think every Member of our body is opposed to that, because if a man advocates things of that kind he doesn't get elected, he doesn't get here. Not here.

So it's their problem and our problem, in that we have assumed to beat the problem and work for them and do for them. I don't believe in giving away things. My record is conservative. I believe in getting along in government matters and getting along on as low a figure as you can, but the tax recommendation proposes to abolish this altogether except for improvements of streets and water mains and schools.

Now, as I say, I know what this means; I come in daily contact with these people. They work in little manufacturing units, and we don't have an abundance of them. But I know how it comes about and how the lack of it—the lack of it—just leaves a vacant spot there and they do have to leave. We ought not to permit that.

Here is a little fellow here who scrimped around and paid for his home and his little place there with it. And he is raising his family. He is a part of the community and pays his taxes, he serves in the church, he backs the school. So we mean to lean over backward trying to tell him to get on down the road? He is entitled to some kind of consideration.

While I understand that there are strong arguments for other uses of bonds, my plea is for the small amount of bonds that are issued for strictly local investments of a kind that will turn the wheels and bring the jobs—bring some jobs—to those that are already there and that's home.

So, it doesn't amount to a great deal of money now to the Treasury, not much.

Now the precedent of taxation here, Mr. Chairman: I have never followed constitutional law, but I tried to learn about it some in law school, and I remember the cases here where early in the Government—doubtless you are very familiar with this, but early in the Government—the question came up whether one government could tax another, or tax the bonds of another, or the earnings of the bonds of another. As you may recall, John Marshall, I think it was, had the final word on that, and he said, "The power to tax is the power to destroy," that the Federal Government can't destroy the States, and the States can't destroy the Federal Government.

Later, much later when the Constitution was amended to take care of the income tax, that principle was recognized and included in the thought of the times; I don't know about the exact wording. But anyway, there was no question of these bonds of the type I am referring to being within the settled law—the settled law—not far from 200 years. So you won't be invading, I submit, be invading any principle of taxation; you will be just following the line that has been the policy.

If there is anything that you think ought to be regulated or modified in this whole problem, it is your duty to serve that purpose. But I just urge you not to totally abolish these little bonds; that's my point. Don't just throw them out among the elements; "root hog or die" is the old expression we used to have. You can't tell the people that; it is contrary to our Government, the old principles of our Government.

They are trying to do something for themselves. Gentlemen, I am talking now about the little bonds—the little bonds put out by a little village or a little town, or some local unit. And that makes a difference in them having some wheels to turn.

And I say I know this day by day. I live there now, and I have always lived there, and I know the people, I know the problems. And just to say that this is all going to stop is just dead wrong.

As I say, I have all respect for those who come here and try to help you in the reasoning, representing the Treasury or whomever they are representing, and I know they act in good faith; but on this subject I think I know more about the human side, the realities of things and the people involved. And I have already related my respect for you, gentlemen, and the problems you have.

So you have others here who want to testify. I was determined not to take up a lot of your time but try to bring as speedily as I could this special problem. These bonds originated with a man in Mississippi who ran for Governor. He was elected, and it made the difference. It spread throughout the Nation.

So if you have any questions that I could try to answer, I would be glad to do it. Otherwise, I thank you very much for your time.

The **Chairman**. Senator, as I read your testimony and listen to your statement, you really are arguing only one point. You are not getting into the argument about whether these create any total new jobs. But as between little towns and big towns, without the capacity to issue these small issue bonds, the little towns just couldn't compete.

Senator STENNIS. Yes, that's right. Not a chance. Not a chance. It is just necessary. Why, we down home—I use my home county—we have had timber. We have had timber all these years. Well, things have changed up on that. We don't have a single operating pulpwood purchasing unit there now. You know what that means. We need help to get new jobs for these people, and these bonds help our small community to do that.

All right. I thank you very much, gentlemen.

The CHAIRMAN. Senator Chafee.

Senator CHAFEE. I want to thank Senator Stennis so much for taking the trouble to come down here and give us his thoughts. He, obviously, knows this subject and has given it a lot of attention. I have talked with him about it in the past, and the points he made are very impressive.

Thank you very much, Senator.

Senator STENNIS. Well, thank you, Senator, thank you very much.

The CHAIRMAN. Thank you very much for coming, John.

Senator STENNIS. Thank you a lot, Mr. Chairman.

Gentlemen, I have a more formal statement here, if I may have your consent to place it in the record.

The CHAIRMAN. Without objection it will be in the record in its entirety.

Senator STENNIS. Thank you very much.

The CHAIRMAN. Thank you.

Senator STENNIS. It is a privilege to be here. Now I want to hear the rest of the testimony, but I want to be out of the way here for the other people, if the gentlemen will kindly put me over there somewhere.

[Senator Stennis' written testimony follows:]

STATEMENT OF SENATOR JOHN C. STENNIS

Mr. Chairman, I want to commend you for holding these hearings on industrial revenue bonds. As you know, for several years I have been urging the committee to get into this matter fully and examine all the facts carefully and closely. So I am delighted that you have set aside a day to examine this subject. I also appreciate the opportunity to appear before the committee.

Mr. Chairman, I speak today for the little fellow—that person in a small rural community who depends upon the local factory for a job to support himself and his family. Without the jobs that these small plants provide, many of our Nation's small towns would begin to die. They are already facing difficult times, as much of the current economic recovery has simply passed them by.

Jobs—that's what the small-issue industrial revenue bond program is all about. These bonds often make the difference for a small plant that is trying to expand or open a new facility. Without this kind of financing, many of these projects simply would not go forward. And many of the people who live in these towns would have no jobs.

Mr. Chairman, my State created the first industrial revenue bond program fifty years ago. Governor Hugh White recognized that Mississippi had to get beyond its heavy reliance on agriculture. He saw that we needed to develop a strong industrial and manufacturing base to provide new jobs for our people. So he pushed through the new industrial bond program.

While I am not an expert in tax-exempt finance—I am not a bond lawyer or anything like that—I have first-hand knowledge of what happened to small towns in my own home area. I have seen our State's economy grow in response to Governor White's initiative. I have watched the growth of small factories, providing good jobs for local people. And I have observed the crucial role that industrial revenue bonds have played in helping create these jobs.

According to my State's research and development center, from 1976 through 1983 industrial revenue bonds were instrumental in the creation of 31,009 new jobs in Mississippi. It is estimated that individual Federal tax payments for 1983 from employees in these new jobs would total $35,784,386. Because of the taxes produced by these new jobs, the Federal Treasury would have a net gain for the 1983 tax year of $4,242,638

Now I recognize that the program has been expanded far beyond the original intent. There have been abuses. I worked with members of this committee last year and in 1982 in trying to eliminate some of these abuses and refine the program. I think we have already imposed a number of significant restraints. The statewide volume cap adopted last year effectively controls the volume of these bonds. It forces States to make careful choices about the purposes for which this form of tax exempt finance can be used.

We have also made sure that these bonds will be used primarily by small companies. We have denied the ability to use these bonds by companies with more than $40 million in tax-exempt bonds outstanding.

Finally, we have directly prohibited the most flagrant abuses of the program. These bonds cannot now be used for fast-food restaurants, country clubs, liquor stores, massage parlors, or automobile dealerships.

I will continue to work with you and the committee in exploring other proposals to reform the program—perhaps through targeting the use of the bonds to areas of high unemployment or through requiring some form of local contribution as a way of increasing local accountability for the uses of the bonds.

But the answer, Mr. Chairman, is to reform the program—not just wipe it out with nothing left to replace it. The President's proposal would simply eliminate the small-issue program. Even if a local government put its taxing power behind the bond, it would not be tax-exempt. In the future only activities such as schools, streets, and sewers could be financed by tax-exempt bonds. I find this blanket elimination most distressing.

That raises the real question, Mr. Chairman. If we completely eliminate these bond programs, what are we going to replace it with? What tools are our small communities going to have to attract industry and create jobs?

We have already slashed Federal spending for economic development assistance. The budget the Senate adopted earlier this spring, for example, eliminates funding for the Economic Development Administration and the Appalachian Regional Commission. Now the administration proposes to eliminate the only other major economic development tool we have left, a tool whose effectiveness in stimulating job creation has been proven time after time.

The administration seems to suggest that we should not try to stimulate economic growth in our small towns. Well, I just do not think it is right to say to a person, "If you want a job, move somewhere else." These people have their families there, own their homes there, have their roots there. It just doesn't seem American to me to say to them, "You've got to move." I wouldn't move, and I don't expect them to.

The industrial revenue bond program operates without any elaborate Govenment bureaucracy. It leaves to local officials the decisions about what projects should be financed and for how much. It lets decisions be made by local businessmen, not Federal Government administrators. The jobs that are created ultimately benefit the whole community, not just a select few.

Mr. Chairman, in Mississippi we have seen the value of these bonds. We do not have the financial resources that some other States have. We cannot offer all the special financial incentives that some States can. We have a rather limited capital base.

Tax-exempt bonds have helped us overcome these difficulties. These bonds have made it economically feasible for companies to take advantage of all the things Mississippi does have to offer—good people, a hard-working labor force, plentiful natural resources, and an excellent quality of life.

To me it just makes no sense to take away a tool we have been using successfully to provide jobs for our people. As the committee continues its deliberations on tax reform, I hope you will keep in mind what this progam means to our small factories and small towns.

The **CHAIRMAN**. Our next witness is Senator Domenici, the Senior Senator from New Mexico, and he is accompanied by Joseph Giglio, the Chairman, Private Sector Advisory Panel on Infrastructure Financing of the Senate Budget Committee.

Senator **Domenici**. Thank you.

The **Chairman**. Thank you, Senator. I am only curious initially, Pete, about one thing. Is your budget so large on the Budget Committee that you can have people paying a great deal of attention to this very detail and significant issue? I am envious if you have that much money.

STATEMENT OF HON. PETE V. DOMENICI, U.S. SENATOR FROM THE STATE OF NEW MEXICO

Senator **Domenici**. Let me suggest that we have a superb group of both private and public sector people that are doing this, and it is at no cost to the Congress. They have done it on their own and will raise the money for it because of their genuine interest.

I might say to you, Mr. Chairman and members of the committee, that while it may seem unusual that we are doing this, frankly, as I look at the Federal budget over the long haul, there is nothing more important than some of the trends I find with reference to infrastructure in this country, and I was genuinely interested in seeing what some experts would tell us about it.

So I thank you for giving me a few minutes, and I will not take very many.

The **Chairman**. Pete, let me advise you: We don't hold the Senators to a time limit here. We do hold our witnesses other than Senators or Cabinet Officers to a 5-minute time limit. You are free to go on as long as you want. But I should forewarn Mr. Giglio that we do keep to that time limit.

Senator **Domenici**. We understand that you have accommodated us, and I think he won't take over three or four minutes, I'm sure.

I have a long statement that I would ask at the end of my testimony and his be made a part of the record.

The **Chairman**. Without objection, it will.

Senator **Domenici**. Last year, Mr. Chairman and members of the committee, I asked a group of private and public sector experts to form a group, an advisory panel on infrastructure financing. Mr. Joseph Giglio who is here, and a former professor and now managing partner of the public finance department for the Wall Street firm of Bear Sterns, was our choice as the chairman of that panel, and I might indicate to you that recently he was named by the full Senate to a membership on the National Council on Public Works.

One of the tasks of this panel will be to analyze the proposals now before your committee for changes in the tax code and the impact of some of these changes on the emerging new partnership and relationships between the private sector and the government as we try to meet our infrastructure needs. That analysis will be completed soon, and we will forward it formally to the Finance Committee membership, to you, Mr. Chairman, for your members, when we finish it. In addition, the infrastructure panel will hold field hearings. They have already started, on their own, in various communities to get testimony from public officials, academicians, and private sector people, those who are actually building the infrastructure for this society. They will have a comprehensive report on this later next year. The appearance here today before you is the very first of their activities, although they have been busy organizing this effort for a long time.

I have been fortunate to have served on the Senate Environment and Public Works Committee and the Budget Committee for almost my entire Senate career, and I have seen two unmistakeable trends; indeed, I would like to think that I have helped begin one of them.

The first clear trend is that Federal investment in the Nation's physical infrastructure—our roads, bridges, water systems, sewer complexes—has at least temporarily peaked. As we battle to bring Federal spending and Federal deficits under control, we simply cannot expect, in my opinion, massive new Federal programs in any area, even one so critical to the basic well-being of our Nation's infrastructure.

The second trend is that State and local governments are responding to this new reality of austerity. Turning to innovative financing techniques such as those pioneered by Mr. Giglio with the State of New Jersey, States have shown flexibility and responsiveness.

Just as States and localities have begun breaking new ground on infrastructure financing, the ground was cut from beneath them. The 1981 tax changes helped States; but the tax provisions of the 1984 Deficit Reduction Act have had a chilling effect on privatization of infrastructure projects through restrictions on leasing provisions involving tax-exempt entities. I understand the rationale; I am not sure we all understood its total impact.

I believe it is critical that Congress not only keep infrastructure financing realities in mind as it reforms the present tax system, but that Congress also go back and repair whatever damage, inadvertent or otherwise, it might have caused with last year's tax bill.

Some of the items we are looking at as we continue our work are reinstating leasing provisions that provide incentives for private participation in public works projects without abusive tax motivations, creating a special asset life class for equipment and structures that are public facilities, and developing a more workable definition of private-purpose facilities as it applies to tax-exempt financing. I hope, Mr. Chairman and members of the committee, that I will be able to be helpful. I will try my very best to give whatever information I can gather.

So let me close by noting that more than 10 major efforts on infrastructure assessment have occurred in just the first 5 years of this decade. The Budget Office, the Congressional Budget Office, General Accounting, Municipal Finance Officers, the National League of Cities, the Conference of Mayors and others, as I indicate in my statement, are among those groups who have conducted studies. The conclusions are unanimous and clear: This Nation faces a crumbling fiscal infrastructure, one that will make it difficult in both urban and rural areas to provide basic goods that Government is charged with providing: clean water, safe travel, efficient and healthy sewer systems. In our legitimate desire to design a fairer and simpler tax code, I hope that we consider, too, our responsibility to help guarantee basic services to our neighbors.

I want to thank you and ask you if you would just indulge our chairman for about 3 or 4 minutes.

The CHAIRMAN. Mr. Giglio.

STATEMENT BY JOSEPH GIGLIO, CHAIRMAN, PRIVATE SECTOR ADVISORY PANEL ON INFRASTRUCTURE FINANCING

Mr. GIGLIO. Thank you very much, Mr. Chairman.

I appreciate the opportunity to testify before the Finance Committee today with Chairman Domenici.

Let me begin where Senator Domenici ended. He cited a series of studies that had been done on needs assessment or demand analysis for infrastructure systems. I think it is fair to say that there is a tremendous unmet need; most of the studies estimate funding shortfalls in the infrastructure categories that the Senator defined and identified that range anywhere from $450 billion to about $1 trillion to the year 2000.

There are a couple of common elements in all of the studies that have been done. One is that there has been an underinvestment in infrastructure systems or goods, particularly over the last 10 to 15 years.

Two, I think it is fair to say that the studies also demonstrate that the issue of infrastructure services and the deterioration thereof is not confined to what has been characterized as "the more fiscally mature Northeast or economically distressed Midwest." I think it is an issue that cuts across geographical lines.

It is also fair to say that those studies demonstrate that the issue of economic development and infrastructure financing are really joined at the hip; that is to say that when one begins to look at increases in transportation and employment in certain sections of the Southwest, that kind of growth is clearly outstripping the capacity, for example in Harris County, TX, of their existing transportation system.

I think it is important to recognize that the issue of infrastructure and economic development really goes to the question of promoting, preserving, and protecting regional economies.

Now, when we look back over the last 4 or 5 years as to how State and local governments have responded to correcting the underinvestment for infrastructure financing, they have used three approaches: One has been the use of a series of creative financing techniques for the establishing of new funding mechanisms; two is to look at new pricing strategies or increasing user fees; and the third has been the approach that I could characterize as "an institutional approach"; in the case of New Jersey, the establishment of a transportation trust authority to fund state highway programs.

Again, the common denominator of these different approaches has been access to the national tax-exempt market. And, two, attempting to leverage private-sector resources with public sector financing.

Now, I think that based on our initial analysis of Treasury II or the President's tax proposals, I think it is fair to say that when you take together the elimination of the deductibility of State and local taxes, the repeal of the ITC, the modifications made to the Accelerated Cost Recovery System, and the fairly broadbased attack on the municipal market beginning with the repeal of tax-exemption for nongovernmental use, the limitations placed on advanced refundings, and other changes that Treasury II will accentuate this funding shortfall between available resources to finance some of the more pressing infrastructure issues, and the potential requirements that have got to be satisfied over the next 18 years.

As we complete our analysis of the tax bill over the next month, consistent with Senator Domenici's comments, we will be sharing it with the Senator and with the Senate Finance Committee.

Again, I appreciate the opportunity to appear this morning, and I would be happy to entertain any questions.

[Senator Domenici's and Mr. Giglio's written statements follows:]

TESTIMONY BY U.S. SENATOR PETE V. DOMENICI

Mr. Chairman, I thank the committee for changing its format for today's hearing in order to accommodate me and Mr. Giglio on the issue of infrastructure needs and financing.

I have a fairly long statement that I would like to have made a part of the record, Mr. Chairman, while I summarize that statement in five minutes or so.

Late last year, the Senate Budget Committee, under my chairmanship, established a private sector advisory panel on infrastructure financing. Mr. Joseph Giglio, a former university professor and now managing partner of the public finance department for the Wall Street firm of Bear Stearns, was our choice as the chairman of the panel. Recently he was named by the full Senate to membership to the National Council on Public Works Improvement.

One of the tasks of the private sector panel will be an analysis of the proposals now before this committee for changes in the Tax Code and the impact of some of those changes on the emerging new partnership between the private sector and Government as we try to meet our Nation's infrastructure needs. That analysis will be completed soon, Mr. Chairman, and we will forward it formally to the Finance Committee membership when we finish it. In addition, the infrastructure panel will hold hearings in six regions of the country during the next year and, working with public officials, academics, and those who actually have to provide infrastructure for society, will have a comprehensive report on infrastructure financing late next year. Our appearance here today is the first of our public activities, although we have been very busy organizing this effort in the last six months.

I have been fortunate to have served on the Senate Environment and Public Works Committee and on the Budget Committee from almost my entire Senate career. I have seen two unmistakeable trends; indeed, I'd like to think that I helped begin one of them. The first clear trend is that Federal investment in the Nation's physical infrastructure—our roads, bridges, water systems, sewer complexes—has at least temporarily peaked. As we battle to bring Federal spending and Federal deficits under control, we simply cannot expect massive new Federal programs in any area, even one so critical to the basic well-being of the Nation as infrastructure.

The second trend is that State and local governments are responding to the new reality of Federal budget austerity. Turning to innovative financing techniques, such as those that Mr. Giglio pioneered working with the State of New Jersey, States have shown flexibility and responsiveness.

Just as States and localities have begun breaking new ground on infrastructure financing, the ground was cut from beneath them. The 1981 changes helped States; but, provisions of the 1984 Deficit Reduction Act have had a chilling effect on the privatization of infrastructure projects through the restrictions on leasing provisions involving tax-exempt entities. I believe it is critical that the Congress not only keep infrastructure financing realities in mind as it reforms the present tax system, but that Congress also go back and repair whatever inadvertent damage it might have caused with last year's tax bill.

Some of the items we plan to investigate as we continue our infrastructure work are reinstating leasing provisions that provide incentives for private participation in public projects without abusive tax motivations, creating a special asset life class for equipment and structures that are public facilities and developing a more workable definition of private purpose facilities as it applies to tax-exempt financing. I hope, Mr. Chairman and members of the committee, to work closely with all of you during the summer on these issues.

Let me close, Mr. Chairman, by noting that more than ten major efforts on infrastructure assessment have already occurred in just the first five years of this decade. The Congressional Budget Office, the General Accounting Office, the Municipal Finance Officers' Association, the National League of Cities, the U.S. Conference of Mayors, the Advisory Commission on Intergovernmental Relations, the Associated General Contractors, the American Public Works Association, the Urban Institute, and the Department of Commerce, have been among those groups who have conducted studies.

The conclusions are unanimous and clear: This Nation faces a crumbling physical structure, one that will make it difficult in both urban and rural areas to provide the basic goods that Government is charged with providing: clean water, safe travel, efficient and healthy sewer systems. In our legitimate desire to design a fairer, simpler Tax Code, I hope that we consider, too, our responsibility to help guarantee basic services to our neighbors.

Thank you for your time, Mr. Chairman, and, with your permission I would like Mr. Giglio to say a few words about our infrastructure panel and some of his initial concerns about some of the tax reform proposals that might be discussed this year by your committee.

TESTIMONY OF JOSEPH M. GIGLIO, GENERAL PARTNER, BEAR, STEARNS & CO.

President Reagan's tax proposal would profoundly damage the ability of state and local governments to finance needed infrastructure improvements at reasonable cost if enacted in its current form. Collapsed sewers and bridges, burst dams and water mains, burgeoning waste disposal facilities, and clogged highways are visible examples of our infrastructure needs. Congress must not overlook the fact that America's economic future rests firmly on its infrastructure. The tax reform debate must take this relationship into account.

It is generally agreed that this country needs to make a greater investment in its public capital assets. Such physical infrastructure is a necessary foundation for economic growth and environmental protection; without these necessities, the economy would falter, and the quality of life and of public services would deteriorate. Projections of the resources available under current financial arrangements fall far short of the estimated amounts required to be invested in such facilities through the rest of this century.

The changes included in the Tax Proposal would widen the disparity between projected needs and available resources at the same time that the federal government has cut back its direct funding of environmental infrastructure projects. The proposed changes would increase the total cost to state and local government of future investments in public infrastructure and decrease private sector interest in participating in such investments. These effects would be particularly severe if all the proposed changes were left unmodified and enacted simultaneously.

The repeal of ACRS to be replaced with lengthened depreciation schedules, the repeal of the Investment Tax Credit, the elimination of the deduction of state and local taxes and numerous modifications in the use of tax exempt financing, when taken together, will significantly reduce the desire of private investors to participate in infrastructure financing, thus, decreasing investment in this area. The interaction of all these changes must be studied to determine their effects on infrastructure financing. The Private Sector Advisory Panel on Infrastructure Financing is currently examining the administration's proposals in detail and will soon report on potential problems and possible solutions.

The proposed changes in depreciation schedules would affect the financing of public facilities because the Accelerated Cost Recovery System (ACRS) applies to much of the tangible property in such facilities. A significant portion of public physical assets currently qualify as 5-year recovery property. For example, 80-90% of the cost of a wastewater treatment facility typically qualifies for a 5-year ACRS deduction. Accelerated depreciation is one of the benefits received by private-sector participants in "full service contracts," under which governments sign long term agreements with private firms to build, own and operate such traditional public facilities as wastewater treatment plants, and solid waste disposal units. Under the Tax Proposal, private sector investors would reduce their equity investment, require greater cash flow from higher user fees, or both, to receive a rate of return sufficient to justify such an investment.

Repealing the investment tax credit (ITC) will have the same kind of dampening effect. The fiscal impact of this particular change would vary from one facility or project to another but it will obviously reduce private-sector investment in revenues-generating, environmentally sound public works.

Eliminating the deductibility of state and local taxes would increase taxpayer resistance and would make it harder for state and local governments to maintain or increase current tax rates at a time when other resources, especially federal grants, are declining. At the same time, the cost of borrowing for state and local government enterprises would likely increase, due to such actions as curbing the tax-exempt status of certain types of government issued bonds. Therefore, more and more pressure would be placed on debt ceilings and property taxes.

In this regard, I note that mounting revenue and financing pressures are already causing governments to accept poorer debt structures and deteriorating balance sheets. In 1984, one major bond rating service downgraded almost 2½ times as many units as it upgraded. This trend portends further disincentives for increasing investment in public physical assets.

The most radical change contained in the Tax Proposal, with regard to infrastructure financing, is the elimination of the tax exemption on all bonds which involve "nongovernmental use." The definition of nongovernmental use includes any private person or business, directly or indirectly, using more than 1% of the proceeds of a bond or more than 1% of a facility built with those proceeds, regardless of the public need for the service provided. The proposed change from exempting bonds whose proceeds are used by private entities for a public purpose to exempting only those bonds that have "governmental" use would impede many types of infrastructure financing.

Resource recovery facilities provide one example in which tax-exempt bonds have been used by governments and private entities for a public purpose. Resource recovery is now a successful partnership between private industry and government in providing a critical public service. Private companies can participate in the construction and operation of multiple plants around the country. The scale upon which such companies operate allows for certain economies and a greater accumulation of expertise, which is critical to the success of many of the newer technologies. In addition, the governmental entity can shift risk, particularly for non-performance of the facility, onto the private owner/operator. When a government uses tax-exempt bonds to finance privately owned or operated public facilities, the costs to users are reduced. The Tax Proposal would substantially alter the economics of the relationships between users, governments, and private investors in public facilities.

There are numerous projects across the country which seek to use private sector investment for the public good. In my home state of New Jersey, both Essex and Bergen counties, the principle uses of the remaining landfills in the Meadowlands area, have turned to a public/private partnership in order to develop adequate facilities for resource recovery.

In addition, private sector investment is critical to the success of many wastewater treatment projects across the nation. The federal Environmental Protection Agency reports that California has $6.7 billion in wastewater treatment needs, in 1984 dollars, for publicly owned facilities through the year 2,000, and Texas has $4.8 billion in needs. Such levels of investment are unlikely to be met if the proposed restrictions on tax-exempt financing are enacted.

While it is appropriate for the Congress and the Treasury Department to review periodically the activities that qualify for tax exempt bonds, the President's proposal seems counter-productive and rigid in its definition of public purpose. State and local governments have the responsibility for providing public infrastructure. A public facility, be it a resource recovery plant, a public road, or a water system, is built for a purpose. Whether the State or local government seeks to attract private participation in the construction, ownership, operation, or use of such a public facility does not change its public purpose. Such a facility retains its public purpose and should retain its tax exempt status. This should be true for public infrastructure currently funded either through exempt activity industrial development bonds or through general obligation bonds.

The tax reform proposal would also impose certain limitations on advance refunding and on the investment of bond proceeds. Advance refunding is a widely used debt management practice. It is usually undertaken to accomplish one or both of two goals: to reduce interest costs and to gain flexibility in using funds.

Bond indentures typically place restrictions on how revenues generated by bond-financed facilities may be expended. They require operating costs and debt service obligations (principal and interest) to be paid. Often they require other reserves, usually to cover operating contingencies, replacement and repair. Requirements placed on revenues in excess of these amounts vary widely from bond issue to bond issue.

A financially successful state turnpike illustrates the significance of advance refunding for infrastructure financing. The outstanding turnpike bonds may have indenture requirements that the toll system can readily meet, but any excess revenues may be limited to generating interest earnings for the turnpike. By refunding the outstanding bonds with an issue that has more flexible indenture requirements, the excess revenues might be used to leverage other bonds, to sustain a revolving loan fund or to serve other transportation infrastructure purposes. Without the refunding, limitations set sometime earlier and not due to expire for years to come would restrict the level of physical investment that the turnpike revenues could sustain.

Eliminating advance refunding would either prohibit or make it more expensive for an issuer to refinance outstanding indebtedness to obtain favorable interest rates or achieve other infrastructure investment purposes. Similarly the Tax Proposal's limitations on how bond proceeds may be invested until they are spent for project costs would increase issuers' debt service costs and would raise the cost of infrastructure financing.

Eliminating the deduction for the interest that financial institutions pay on the funds used to purchase municipal bonds would increase the cost of funds for commercial banks purchasing new tax-exempt debt. This change would create a strong disincentive for banks to purchase new issues of municipal bonds.

Property and casualty companies, which are major buyers of municipal bonds, would also face disincentives to the holding of tax-exempt bonds because of the proposed requirement that they allocate a portion of their tax-exempt income to policyholder reserves.

In conclusion, taxpayers want to feel that the tax and fee burdens they bear are commensurate with the value of the benefits they believe they are receiving from public facilities and services. Facility costs will depend in part in how well a facility is managed and in part on how much it costs to construct, with the latter heavily influenced by the cost of capital. The interest exemption for state and local bonds and deductibility of state and local taxes directly affect the interest rates governments must pay on their bonds and voters' perceptions of how much of a burden taxes and service fees constitute. As that burden rises, for whatever reason, there is less incentive when the personal benefits are not obvious.

Financial resources for infrastructure investment will be generated more easily if public expenditures leverage private spending. Tax laws are vitally important in this process because they can help or hinder private sector participation. Frequent or sweeping changes to tax laws do not engender the confidence and stability that private investors prefer before committing their resources.

Our tax system may need changing. At the same time, our nation needs to invest more in its public physical assets to maintain a viable economy and an acceptable quality of life. Infrastructure investment need not be at odds with tax reform, but I believe the Tax Proposal in its present form would actively discourage needed investment in our public assets. A more reasonable balance needs to be struck.

INFRA$TRUCTURE
FINANCING

Private Sector Advisory Panel On Infrastructure Financing

THE IMPLICATIONS OF TAX REFORM
FOR
INFRASTRUCTURE FINANCING
AND
CAPITAL FORMATION

Submitted to

The Committee on the Budget
United States Senate

July 16, 1985

THE IMPLICATIONS OF TAX REFORM FOR INFRASTRUCTURE FINANCING AND CAPITAL FORMATION

Summary: It is vitally important to our national well-being that investment increase in public physical infrastructure. As presented, the Tax Proposal would severely decrease infrastructure investment. The Panel provides a definition of public purpose and recommends that all facilities falling within that definition be eligible for tax-exempt financing and that ownership or management of certain facilities by nongovernmental entities not automatically preclude tax-exempt financing. The Panel also recommends that projects meeting the public-purpose standard be exempted from any industrial development bond caps, be granted a tax credit, and be defined as Class 2 property under the proposed Capital Cost Recovery System, and that current laws and regulations concerning public purpose bond refundings and arbitrage earnings apply to such projects.

INTRODUCTION

President Reagan released his Tax Proposals to the Congress for Fairness, Growth, and Simplicity (the Tax Proposal) on May 28, 1985. The Tax Proposal would profoundly reduce the ability of state and local governments to finance needed infrastructure improvements at reasonable cost if enacted in its current form.

It is generally agreed that this country needs to make a greater investment in its public capital assets or infrastructure at all levels. Such physical infrastructure is a necessary foundation for economic growth and environmental protection; without these necessities, the economy would falter and the quality of life and of public services would deteriorate. Nonetheless, investment in such public physical assets has declined in real terms over the last decade by nearly 30%. Where twenty years ago such investment was the equivalent of about 3.5% of the gross national product (GNP), it now has declined to slightly more than 2%.

The Joint Economic Committee (JEC), which recently completed a major national study assessing infrastructure needs, identified funding needs of $1.1 trillion to finance infrastructure facilities through the year 2000. The Congressional Budget Office (CBO) projects a lower but still large level of need, $860 billion, to meet the nation's infrastructure needs through the year 2000. Using this range of estimates from CBO and the JEC, this country will have to spend between $57 and $73 billion annually to keep pace with its infrastructure needs. The actual annual expenditure for infrastructure in FY 1984 from federal, state, and local sources has been estimated by CBO at $41 billion.

Projections of the resources available under current financial arrangements fall short, by hundreds of billions of dollars, of the estimated amounts required to be invested in such facilities through the rest of this century. The changes included in the Tax Proposal would widen the disparity between projected needs and available resources at the same time that the national government has cut back its direct funding of environmental and other infrastructure projects. The proposed changes would increase the total cost to state and local governments of future investments in public infrastructure and decrease private sector interest in participating in such investments.

This paper will focus on those provisions in the Tax Proposal that would directly affect public-private collaboration in financing public physical facilities and would affect the tax-exempt status of instruments that are used to finance such facilities. If left uncoordinated and enacted simultaneously, these changes would have a severe impact upon the level of infrastructure investment.

Public physical assets constitute the infrastructure of concern here, encompassing such things as roads, bridges, prisons and jails, schools, university buildings, water and sewage treatment plants, dams, park and recreation developments, solid waste disposal facilities including landfills and resource recovery plants, government offices, airports, water terminals, and other similar public assets. In general, this paper and the work of the

Private Sector Advisory Panel on Infrastructure Financing focus on those facilities which are revenue generating because these facilities offer the greatest opportunities for innovative financing. Consequently, little reference is made to educational and public safety facilities. The emphasis here will be upon traditional "public works": transportation, water supply, wastewater systems and solid waste disposal.

PUBLIC-PRIVATE COLLABORATION IN INFRASTRUCTURE

Financing

In recent years public-private collaboration in financing investments in public physical assets has increased and taken new and innovative forms. The great need for public facilities, coupled with the lack of available financing, has led state and local governments to seek investment of private capital in public works to augment declining federal funds and the traditional use of tax-exempt general obligation bonds and revenue bonds.

In addition to increasing use of private capital, there has been an increase in the use of private sector expertise to design, build, and operate public facilities. State and local interest in collaborating with private firms is based on several factors including:

(1) limiting risk to the government entity by shifting or sharing the risk with the private firm, and

(2) reducing or stabilizing the rates charged to users through construction savings, operating efficiencies and improved maintenance.

The public sector can choose which types of benefits are realized. Private companies may construct a facility on a turn-key basis and a public body may eventually operate it. A private company may both construct and operate a public facility under a long-term performance contract with a public owner. Finally, a private company may construct, operate and own the facility. Public-private collaboration may be beneficial not just because of the technical complexity of some activities, but because of the proprietary nature of state-of-the-art systems in areas such as resource recovery.Aspects of the tax code important to public-private cooperation are the use by private investors of the Accelerated Cost Recovery System (ACRS) and the Investment Tax Credit (ITC), and the use of tax-exempt bonds to finance these public-private ventures. The following sections will discuss each of these aspects of the tax code and how the Tax Proposal would change them.

ACCELERATED COST RECOVERY SYSTEM

Current Law

Under the ACRS, all depreciable property is divided into five classes with recovery periods of 3, 5, 10, 15 and 18 years. Most personal property, including machinery and equipment, falls into the 5-year category; most real property falls into the 18-year category (unless it was placed in service on or before March 16, 1984). Regulated public utility property may be classed as 5-, 10-, or 15-year property depending upon its treatment under pre-ACRS law.

In addition to providing a recovery life for property that is generally shorter than its actual economic life, the ACRS allows accelerated depreciation schedules which deduct the largest percentages of the total depreciation in the earlier years of the property's useful life. (This is known as the "declining balance" method; distributing depreciation equally over the asset's life is known as the "straight line" method.) The ACRS deductions are taken against the property's basis (cost), adjusted by subtracting one-half of any ITC taken for the property. If straight line depreciation has not been used, ACRS deductions are subject to "recapture" when the property is sold; that is, for most types of property, all previously allowed excess depreciation constitutes ordinary income rather than capital gain.

Property financed through tax-exempt industrial development bonds (except for multifamily housing) must be recovered through the straight line method of depreciation over the applicable ACRS life.

Tax Proposal

The Tax Proposal would replace the ACRS with a Capital Cost Recovery System (CCRS) designed to group assets according to their useful economic lives and provide a uniform incentive for investment in depreciable assets. Under the CCRS, depreciable property would be divided into six classes, with ACRS 5-year property reclassified into classes 2 through 5 (see Table 1). Each class would be assigned a fixed annual depreciation rate ranging from 55% to 4%. The assigned rate would be applied against the indexed, inflation-adjusted, remaining, unrecovered basis of the asset. Under this approach, the taxpayer would never fully depreciate an asset. Therefore, the Tax Proposal provides for a conversion to the straight line method which would complete recovery of the cost of the asset through 100% depreciation in the close-out year assigned to that asset class. Thus, for former 5-year property which has been assigned to class 4, the taxpayer would depreciate 22% of the indexed basis each year until it reached the fifth year; at that point the depreciation would convert to a straight line method, with the asset being fully depreciated in the eighth year (see Table 2).

As under present law, taxpayers could continue to expense up to $5,000 worth of personal property in lieu of using the CCRS. First year allowances would be prorated for the number of months the property is in service. The Tax Proposal would eliminate the special capital gains rate for depreciable assets; therefore, recapture no longer would be an issue. The CCRS would be in effect for property purchased on or after January 1, 1986.

The proposed changes in depreciation would affect the financing of public facilities, because the ACRS applies to most of the tangible property in such facilities. A significant portion of public physical assets currently qualify as 5-year recovery property. For example, 80-90% of the cost of a wastewater treatment facility typically qualifies for a 5-year ACRS deduction. Under the proposed CCRS, these depreciation schedules would be lengthened for most equipment to 7 to 10 years. Depreciation schedules keenly affect private sector interest in "full service contracts," under which governments sign long-term agreements with private firms to build, own and operate such traditional public facilities as wastewater treatment plants and solid waste disposal units. Depending on their assumptions about future inflation rates, private sector investors might reduce their equity investment, require greater cash flow from higher user fees, or both, to receive a rate of return sufficient to justify such an investment.

Table One

CCRS Asset Classes

CCRS Class	Classification of ACRS Property 1/	Depreciation Rate 2/	Recovery Period 3/
Class 1	3-year property	55 %	4
Class 2	Trucks, Buses, and Trailers Office, Computing, and Accounting Equipment	44 %	5
Class 3	Construction Machinery, Tractors, Aircraft, Mining and Oil Field Machinery, Service Industry Machinery, and Instruments	33 %	6
Class 4	5-year, 10-year, and 15-year public utility property not assigned to Class 2, 3, or 5 -- E.g., Metal Working Machinery, Furniture and Fixtures, General Industrial Machinery, Other Electrical Equipment, Communications Equipment, Fabricated Metal Products, and Railroad Track and Equipment	22 %	7
Class 5	Railroad Structures, Ships and Boats, Engines and Turbines, Plant and Equipment for Generation, Transmission and Distribution of Electricity, Gas and Other Power, and Distribution Plant for Communications Services	17 %	10
Class 6	18-year property; 15-year low-income housing	4 %	28

Office of the Secretary of the Treasury May 28,1985

1/ Items of property are assigned to CCRS classes under rules described in the text of the General Explanation.

2/ The depreciation method switches from a constant declining-balance rate to the straight-line method in the year of service in which the straight-line method produces greater depreciation allowances than the declining-balance rate would, assuming a half-year convention for computation of the straight-line method.

3/ The recovery period is the number of years over which cost recovery is computed under the straight-line method. A consequence of assuming a half-year convention for purposes of computing depreciation rates under the straight-line method is that depreciation schedules cover one year more than the recovery periods.

Table Two

Capital Cost Recovery System Depreciation Schedule (as a Percent of Inflation-Adjusted Basis) 1/

Year	Class 1	2	3	4	5	6
1 2/	27.5	22	16.5	11	8.5	2.00
2	55	44	33	22	17	4.00
3	55	44	33	22	17	4.00
4	67	44	33	22	17	4.00
5	100	67	40	29	17	4.08
6		100	67	40	18	4.26
7			100	67	22	4.44
8				100	29	4.65
9					40	4.88
10					67	5.13
11					100	5.41
12						5.71
13						6.06
14						6.45
15						6.90
16						7.41
17						8.00
18						8.70
19						9.53
20						10.53
21						11.76
22						13.33
23						15.38
24						18.18
25						22.22
26						28.57
27						40.00
28						66.67
29						100.00

Office of the Secretary of the Treasury May 28, 1985

1/ A half-year convention is assumed for purposes of determining the year in which the depreciation schedule switches from the declining-balance rate to the straight-line method. Consequently, the depreciation schedules cover one year more than the recovery period for each class.

2/ First-year allowance shown assumes an asset is placed in service by a calendar year taxpayer on July 1, without regard to the mid-month convention. Actual allowance in first year would vary depending on when asset is placed in service.

INVESTMENT TAX CREDIT

Current Law

Current law provides a tax credit for investment in certain types of depreciable property, which generally includes personal and other tangible property, but does not include buildings and their structural components. (There is, however, a tax credit for rehabilitated buildings.) In most cases, the ITC equals 10% of the costs, except where the ACRS classifies the property as 3-year property, which generally receives a 6% ITC. The ITC is subject to recapture, and one-half of it must be subtracted from the asset's basis before depreciation. The amount of tax liability that may be offset by ITCs in any year is limited to $25,000 plus 85% of the tax liability in excess of $25,000.

A wastewater treatment facility provides an example of how the ITC operates in the case of a public capital facility. "Other tangible property" for such a facility must meet two tests to qualify for the ITC. First, the structure can be expected to be replaced when the equipment it houses is replaced. Second, the structure cannot be economically used for another purpose. In general, 80-90% of the cost of a typical wastewater treatment facility will qualify for the 10% ITC.

Normally, the ITC is claimed in the first year that a facility is in service. For projects with a construction period greater than 24 months, however, the ITC can be claimed on a progress expenditure basis. Although land does not qualify for the ITC, land improvements, including roads, excavation and concrete, may qualify. Therefore, the costs not qualifying for an ITC would typically be a relatively small portion of the total cost of some public physical assets such as a wastewater treatment or resource recovery facility.

Tax Proposal

The Tax Proposal would repeal the ITC on property purchased on or after January 1, 1986. The fiscal impact of this change would vary from one facility or project to another. The National Resource Recovery Association, for example, estimates that, without the ITC, municipal disposal costs related to resource recovery facilities would rise between 10% and 20% per ton of refuse.

The initial revenue losses caused by provisions such as ACRS and ITC may be partially or totally offset by revenues collected from the private-sector entity. The tax effects will vary according to whether or not construction industry capacity would otherwise be employed or idle, how profitable the operation is for the private firm, how long a municipality might have to wait before debt limitations or grants were sufficiently available to make construction feasible, and the extent to which any economic development may occur because of the new capacity to provide a desired public resource, such as clean water. Therefore, the net effect of the current tax provisions as they are applied to public-private collaborations in infrastructure is not necessarily a loss in federal revenues. Whatever their revenue consequences, current tax provisions do encourage private firms to collaborate with state and local governments in meeting large infrastructure investment needs, especially in activities required to preserve and protect the environment.

TAX EXEMPT FINANCING FOR INFRASTRUCTURE

Tax exemption of interest on bonds issued by states and localities has a long history. A series of Supreme Court decisions between 1819 and 1895 established the doctrine of "reciprocal immunity," which holds that states are immune from federal interference just as states may not interfere with federal government affairs. The 16th Amendment gives Congress the right to collect taxes on income "from whatever source derived." Scholars and constitutional attorneys have debated the effect of this amendment on reciprocal immunity. The legislative history and a series of Supreme Court decisions have limited the phrase to apply only to the distinction between direct and indirect taxes. Therefore, the legality of federal taxation of state-issued bonds is not settled in the law.

State and local governments have used tax-exempt bonds to finance infrastructure since the 1800s. As the responsibilities of government for infrastructure have grown, so has the use of tax-exempt debt.

Currently, general obligation bonds, enterprise revenue bonds, and industrial development bonds (IDBs) are used to finance infrastructure projects. However, IDB financing of infrastructure facilities has been a relatively small part of the total IDB volume. The discussion which follows considers IDB financing, but only as it is limited to financing public purpose infrastructure facilities, not as it has been or may be applied to a variety of other commercial and so-called nongovernmental or "private" purposes.

Current Law

The general interest exemption on state and local governmental bonds is provided in Section 103(a) of the Internal Revenue Code. These bonds are usually either general obligation bonds, secured by the full faith and credit of a state or local government, or revenue bonds, secured by the operations of a governmental enterprise. In addition, certain other bonds issued by state and local governments may be tax-exempt. These other bonds include: industrial development bonds which, although used to finance the activities of a private business, are tax-exempt if they qualify as small issues (until 1986) or if they are issued to finance certain exempt activities; mortgage subsidy bonds; student loan bonds; and bonds issued to benefit tax-exempt institutions, primarily not-for-profit health care facilities and private educational institutions. Exempt infrastructure activities for which IDBs currently may be used include wastewater treatment plants, resource recovery facilities, docks and wharves, airports and mass transit facilities.

Through 1986, there is an annual per-state volume cap on IDBs and student loan bonds equal to the greater of $150 per capita or $200 million. Thereafter, the cap will be $100 per capita or $200 million. Furthermore, property financed with IDBs must be depreciated by the straight line method over the applicable ACRS life.

Advance refunding of most tax-exempt bonds is permitted under current law (IDBs and mortgage subsidy bonds are the primary exceptions). Advance refunding involves issuing bonds and using the proceeds to retire previously outstanding bonds before the latter reach their stated maturity date. Current law does not classify a transaction in which the retirement of the outstanding debt takes place within 180 days of the issuance of the refunding bonds as an "advance" refunding.

Tax Proposal

The Tax Proposal recommends that tax-exemption be denied where more than 1% of the proceeds of the issue, including facilities financed with such proceeds, are used directly or indirectly by a person other than a state or local government. The Tax Proposal includes an exception for proceeds or facilities which are used by the general public.

The Proposal states that general obligation bonds, the proceeds of which are generally used to finance "traditional government functions," will remain tax-exempt. However, it is important to note that all bonds, including general obligation ones, would have to pass each of two new tests to be tax-exempt.

First, no more than 1% of the bond proceeds could be used by a nongovernmental person. In addition to a use test, current law contains a security interest test that must be satisfied before the bonds are treated as issued for a governmental purpose. The proposed 1% standard would eliminate the security interest test. Under this test, a portion of the debt service on the bonds may be secured by, or derived from, property used in a private trade or business. For example, in a multi-modal transportation center, up to 25% of the debt service currently could be derived from rental payments from private bus, trucking or shipping companies. Under the Proposal, no more than 1% of the space could be used by such firms and have the bonds remain tax-exempt, even if no rentals were pledged or otherwise used to pay debt service.

Under the Proposal's second test for any bond to be tax exempt, the financed facilities must be available for actual use by the general public on the same basis as a private user. Precise definitions have not been established but an airport provides an example. Parts of the airport that are open to the general public (main concourses, parking lots, etc.) would clearly be eligible for financing with tax-exempt securities. However, special access roads for freight terminals to be used almost exclusively by trucking companies, or terminal and hangar facilities used by the private airlines, neither of which could be used by the general public, would not be eligible for tax-exempt financing. Because the "use" of runways, taxiways, and gates is mixed, such assets also may not be eligible for tax-exempt financing. The same argument could be used to deny tax exemption on either general obligation or revenue bonds used to finance water ports.

The Tax Proposal would allow tax-exempt financed facilities to be used by a nongovernmental entity only under a short-term management contract. For example, a solid waste disposal facility serving the general public could be financed with tax-exempt bonds if it were owned by a city and operated by the city or by a private operator under a one-year contract.

If the proceeds were made available to a nongovernmental entity to construct a privately owned solid waste disposal facility, however, or if the city signed a long-term management contract with a private contractor, the bonds would not be tax-exempt. Allocation rules would be provided for facilities where the uses were partly public and partly private, but they have not been included as part of the Tax Proposal.

The tax exemption would be preserved for bonds which finance ordinary government operations and government buildings, unless more than 1% of a facility were leased to a nongovernmental entity. This restriction could easily pose a problem in cases where government buildings include privately run cafeterias, news stands or canteens. Certain IDB requirements under current law, such as reporting requirements, would be extended to all tax-exempt bonds, and other restrictions, such as the prohibition on federal guarantees of tax-exempt debt, would be retained.

The Tax Proposal would effectively prohibit tax exemption for both general obligation and revenue bonds used to finance activities which are exempt under sections 103A or 103(b). These activities include, among others, student loans, capital projects for private nonprofit hospitals and universities, airports and docks, many sewage and waste disposal facilities, pollution control projects for private companies, mass transit commuting facilities, urban redevelopment, and disaster relief. While it is certainly appropriate for Congress to review periodically the list of activities that should qualify for tax-exempt financing, there should be no question that the financing of public purpose infrastructure facilities should remain tax-exempt.

Eliminating these exempt activity bonds would constrain the developing public-private partnership that has proven to be a promising way of financing needed infrastructure facilities, particularly in the area of wastewater and solid waste treatment. Given the increasing sophistication and complexity of waste treatment technology, many local governments have found that these facilities can be constructed and operated far more efficiently and effectively by private-sector experts. Tax-exempt bonds are an integral part of the financing of such facilities, and their elimination would force these communities to turn to less effective and more expensive means of providing this service.

All advance refundings of tax-exempt bonds would be prohibited under the Tax Proposal. Refundings would be permitted only if the refunding transactions occur immediately after the refunding bonds are issued. These prohibitions would apply to all obligations issued on or after January 1, 1986. In addition, practices that result in arbitrage earnings (investing tax exempt proceeds in taxable obligations) would be severely constrained.

The provisions in the Tax Proposal raise the following issues:

1. How to define "public purpose" and how to establish its presence, particularly the reasonableness of the 1% rule.

2. The appropriateness and feasibility of the limitations on refundings and arbitrage earnings.

Public Purpose and the 1% Rule

The most radical change contained in the Tax Proposal, with regard to infrastructure financing, is the way it substantially narrows the amount of "nongovernmental use" that will be permitted in facilities financed with tax-exempt bonds. The definition of "nongovernmental use" includes the use, directly or indirectly, of more than 1% of a facility by any person other than a state or local government, regardless of the public nature of the service provided. The proposed change from exempting bonds that have a "public purpose" to exempting only those bonds that sustain facilities used by a government would impede many types of infrastructure financing.

Resource recovery facilities provide one example in which tax-exempt bonds have been used to finance facilities owned or operated by a private entity for a public purpose. They display a successful partnership between private industry and government in providing a critical public service, particularly as alternative disposal methods such as landfilling, ocean dumping and incineration become physically less feasible and environmentally less desirable. The advantages of public-private collaboration are of particular importance in the resource recovery field due to the proprietary technologies involved and the level of technological expertise required.

If a resource recovery facility could be financed with tax-exempt bonds if it were owned and operated by a state or local government, why should the bonds become taxable simply because the governmental entity concludes that it wants to avoid the risks of owning and operating the facility or that it could be operated more effectively and efficiently by a private entity? In other words, if the tax exemption is available for a public purpose, why should not the governmental entity be free to choose the best method for meeting the public purpose?

There are also many instances where private entities use government-owned facilities to provide a service which augments the amenities of a government facility. Turnpikes and toll roads are one example. Private companies lease publicly owned facilities to provide the traveling public with fuel, food and rest. Under the Tax Proposal, such convenience facilities would probably have to be either government owned and operated or financed with taxable debt.

The Tax Proposal would permit a governmental service, such as roads, water or sewers, to be extended to benefit a private individual, provided that "access" is the same as that available to the general public, but the Tax Proposal does not define what constitutes equal access. Does equal access require a government to establish uniform pricing for all users of a system? If so, uniform pricing could impose higher costs on all users by limiting the ability of a government to influence use and manage demands on infrastructure through a multiple rate structure.

Pricing restrictions may also impede rehabilitation or expansion efforts at existing water supply and wastewater facilities, particularly small facilities in rural areas. If a service area has one or more large, dominant users, the security supporting a water or wastewater financing rests, in part, on the stability of those large users. To increase the security for the financing, many issuers have entered into agreements which require a large user to pay a fixed percentage of the annual debt service requirements of bonds issued for a particular facility. The large users could be considered as having access to the facility which differs from the general public's access. Because of this difference, future investments in improvements to plant and equipment might not be eligible for financing with tax-exempt bonds.

The Tax Proposal also would introduce uncertainty in defining a "user." For example, if a state water authority sells water to local systems for resale to customers, are the local systems the users for determining eligibility for tax-exempt financing? If the customers instead are deemed to be the users, would the tax-exemption be denied if any customer had signed a contract providing a two-tiered payment, or used more than 1% of the water? In sum, the requirements set forth in the Tax Proposal could jeopardize tax-exempt financing for traditional government functions such as water supply and sewage treatment.

Limitations on Advance Refunding and the Investment of Bond Proceeds

Advance refunding is a widely used debt management practice. It is usually undertaken to accomplish one or both of two goals: to reduce interest costs and to gain flexibility in using funds.

Bond indentures typically place restrictions on how revenues generated by bond-financed facilities may be expended. They require operating costs and debt service obligations (principal and interest) to be paid. Often they require other reserves, usually to cover operating contingencies, replacement and repair. Restrictions placed on revenues exceeding expenses, debt service and reserves vary widely from bond issue to bond issue.

A financially successful state turnpike illustrates the significance of advance refunding for infrastructure financing. The outstanding turnpike bonds may have indenture requirements that the toll system can readily meet, but any excess revenues may be limited to generating interest earnings for the turnpike. By refunding the outstanding bonds with an issue that has more flexible indenture requirements, the excess revenues might be used to leverage other bonds, to sustain a revolving loan fund or to serve other transportation infrastructure purposes. Without the refunding, limitations set sometime earlier and not due to expire for years to come would restrict the level of physical investment that the turnpike revenues could sustain. Delaware, Indiana, Maryland and New Jersey have all used advance refundings to take advantage of their toll roads to finance other transportation improvements.

Advance refundings are also undertaken when interest rates drop below the rates on an issuer's outstanding debt. The individual government refinances its debt to lower its interest costs. The Tax Proposal argues that such refundings place additional demands on the capital market by increasing the supply of available debt, which tends to drive up interest rates, and that overall market rates would presumably be lower if this capital demand were not present. Under the Tax Proposal, refundings could take place only if the outstanding bonds were immediately callable. The Tax Proposal, in effect, reduces a state or local government's flexibility in timing a refunding to coincide with the availability of more favorable interest rates.

In addition to eliminating most advance refundings, the Tax Proposal calls for rebating to the U.S. Treasury all arbitrage earnings on nonpurpose obligations acquired with the proceeds of tax-exempt bonds (subject to certain "temporary period" exceptions). Nonpurpose obligations are taxable securities, such as U.S. Treasury bills and notes, acquired with money set aside in reserve funds, awaiting construction expenditures or accumulating to pay debt service. Furthermore, the rate at which proceeds of tax-exempt bond issues could be reinvested would be constrained to the yield on the bond issue without regard to the costs associated with issuing the bonds.

The Tax Proposal also requires all bond proceeds to be expended within three years of the date of issuance. Infrastructure projects are often quite large and can take more than three years to construct. For such projects, bonds would have to be issued more than once. Depending on what happens to interest rates between the issuance dates, borrowing costs might rise substantially. The Proposal would prevent governmental entities that undertake large, long-term projects from fixing their financing costs at the time construction begins.

In trying to curtail some abuses, the Proposal unnecessarily burdens the day-to-day operations of state and local governments which will have to choose between complicated accounting, reporting and rebating requirements, or limiting their reinvestments to the tax-exempt bonds of other issuers. The Tax Proposal's rebate requirements are too sweeping. They should be limited to the abuses, and not impede the operations of state and local governments generally.

In short, the Tax Proposal as written would restrict widely accepted cash management practices and have a direct effect on issuers' debt service costs, inhibiting investments in public physical infrastructure. Issuers would be less able to arrange favorable interest rates and to remove restrictive bond covenants, nor could they include issuance costs in calculating interest rates paid. Furthermore, the arbitrage restrictions are not easily capable of implementation and fail to give sufficient weight to the inevitable difficulties that arise in trying to match the flow of bond proceeds with construction progress and cash needs.

Eliminating Long-Term Service Contracts for Tax-Exempt Facilities

If a state or local government wants a private firm to operate a facility financed by tax-exempt debt, the Tax Proposal would restrict such contracts to one year in length. This provision would make currently highly-successful service contracts unattractive to private-sector contractors and to governmental entities. Short-term contracts discourage operators from doing longer-term planning and maintenance and from keeping employees updated with regularized training. Under these provisions, operating arrangements would be subjected annually to the vagaries and frustrations of complicated procurement procedures. The Tax Proposal would inhibit a state or local government from exploring whether the advantages of efficient, stable and consistent facility management can be better achieved through private sector participation. The state or local government would also be unable to secure performance guarantees for the life of a facility under a short-term contract, leaving the state or municipality to shoulder the risk.

Other Issues Affecting Infrastructure Financing

The Tax Proposal includes changes that would affect the nature of investors in tax-exempt debt. Eliminating the deduction for the interest that financial institutions pay on the funds used to purchase municipal bonds would increase the cost of funds for commercial banks purchasing new tax-exempt debt. This change would create a strong disincentive for banks to purchase new issues of municipal bonds. Because commercial banks tend to dominate the market for intermediate maturities (5-15 years), lowering demand would raise interest rates for these maturities relative to taxable rates.

Bank purchases are especially important in smaller communities with small issues which lack access to the broad national market and perhaps even to regional ones. The infrastructure activities of these governments would be greatly damaged by the declining bank purchases of municipal securities that the Tax Proposal would tend to bring about.

Property and casualty insurance companies also are major buyers of municipal bonds, particularly bonds with maturities of 20 years or greater. The Tax Proposal would make tax-exempt bonds a less attractive vehicle for fixed-income investment by requiring these companies to allocate a portion of their tax-exempt income to policyholder reserves. Whether the absence of these buyers would add to the upward pressure on rates caused by a reduction of commercial bank purchases remains to be seen.

Finally, two other provisions of the Tax Proposal will significantly affect infrastructure financing, but they are not discussed in detail here because of their far-reaching implications: rate changes and the deductibility of state and local taxes. Rate reduction is one of the primary motivations behind tax reform. However, significant reductions will reduce the interest rate differential that currently exists between taxable and non-taxable debt instruments. Non-taxable rates will need to rise to remain competitive in the search for capital. Ignoring possible changes in the supply of debt that other provisions of the Tax Proposal might induce, the effective interest rates on state and local bonds would be expected to rise in the short term. Most public physical assets are debt financed and higher interest rates will make them more expensive.

Whether to continue, modify or eliminate the deductibility of state and local taxes in calculating personal income tax liabilities is one of the most disputed provisions in the Tax Proposal. As written, the Proposal would eliminate deductibility entirely, a change that would have a dramatic effect on state and local finances, including infrastructure financing. Eliminating deductibility could increase taxpayer resistance and could make it harder for state and local governments to maintain or increase current tax rates at a time when other resources, especially federal grants, are declining.

A variety of forces, including the impending tax changes, are placing more and more pressure on local debt ceilings and property taxes. Mounting revenue and financing pressures have already caused governments to experience poorer debt structures and deteriorating balance sheets. In 1984, one major bond rating service downgraded almost 2 1/2 times as many units as it upgraded. This trend portends further disincentives for increasing investment in public physical assets.

CONCLUSIONS AND RECOMMENDATIONS*

The Panel concludes that it is vitally important to our national well-being that investment increase in public physical infrastructure. The Tax Proposal would severely decrease infrastructure investment. The following recommendations would mitigate some of the negative aspects of the Tax Proposal on infrastructure financing. The Panel focuses its recommendations entirely on policies that directly affect infrastructure activities.

Public Purpose

The Panel recommends that, for purposes of the restriction on nongovernmental bonds contained in the Tax Proposal, public purpose infrastructure facilities as defined below remain tax exempt and not be subject to the restriction.

Public purpose infrastructure facilities are defined as follows:

> **(1) airports, docks, wharves, mass commuting facilities, parking facilities, or storage or training facilities directly related to any of the foregoing, provided that such facilities serve or are available on**

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*The statements in this section reflect the consensus of the Panel; they do not necessarily reflect the view of a specific member on a particular point.

a regular basis for general public use or are part of a facility which serves or is available on a regular basis for general public use;

(2) water pollution control facilities and sewage, or solid waste disposal facilities, including landfills and resource recovery plants;

(3) facilities for the local furnishing of electric energy, gas or water for any purpose, provided that such energy, gas, or water will be made available to members of the general public and either the facilities are owned by a governmental unit or the rates for the furnishing or sale of energy, gas or water will be established or approved by a State or a political subdivision thereof, by an agency or instrumentality of the United States, or by a public service or public utility commission or other similar body of any State or political subdivision thereof;

(4) qualified mass commuting vehicles; and

(5) facilities which (a) a state or local government is required by federal, state or local law to provide, or (b) serve or are available on a regular basis for general public use or are part of a facility which serves or is available on a regular basis for general public use.

Bonds issued to finance public purpose infrastructure facilities enumerated in (1), (2), (3) and (4) above shall be tax-exempt without regard to ownership or management by nongovernmental persons and without regard to the duration of any lease or management contract to which the public purpose infrastructure facility is subject. Bonds issued to finance a public purpose infrastructure facility defined in (5) above shall remain tax-exempt provided that such facility is owned by a state or local government and not more than a major portion of such facility is used by any person other than a state or local government.

This definition builds upon the statement in the Tax Proposal (p. 285) that exemption would be continued for obligations issued to finance "ordinary government operations" and "the acquisition or construction of government buildings." It has several advantages, however, over other provisions in the Tax Proposal. First, except for facilities described in (3) and (5), it eliminates government ownership or use as the criterion for determining tax exemption eligibility for the enumerated infrastructure facilities and focuses instead on the public purpose nature of such facilities. Secondly, the public use requirements for categories (1) and (5) comport with those presently applied to IDB-exempt facilities which require that the facilities serve or be available on a regular basis for general public use, or be part of a facility that is so used. Under this language, for example, an airport used by common carriers would meet the public use requirement because the carriers are required to serve the general public and the airport facility is itself available for use by the general public. Finally, it solves the "cafeteria problem" by retaining existing statutory language that allows nongovernmental use of up to 25% of the space in a public building.

Industrial Development Bonds

The Panel recommends that public purpose infrastructure facilities as defined above be eligible for financing with industrial development bonds and that such bonds be tax exempt and not subject to volume caps.

If a public purpose meeting the standards proposed above is being financed with bonds, the debt instruments involved should be tax exempt. Given the large existing gap between available resources and needed investments in public physical infrastructure, caps on the volume of private activity bonds should not apply to bonds issued to finance public purpose infrastructure facilities. Such caps will become increasingly constraining in future years, especially in meeting environmental standards.

Infrastructure Investment Tax Credit

The Panel recommends that an infrastructure investment tax credit be provided for public purpose infrastructure facilities as defined above.

ACRS Conversion to CCRS

The Panel recommends that property in an infrastructure facility, and which is currently defined as five-year property under ACRS, be placed in Class 2 under the proposed CCRS.

The gap between the resources invested in public purpose infrastructure facilities and the need for them will not be closed adequately without private-sector participation. Current ACRS and ITC tax provisions encourage such participation but apply to activities that go well beyond public purpose infrastructure facilities. Such tax advantages serve an important public purpose in this instance and should be continued at least in this narrowed form.

Refundings and Arbitrage

The Panel recommends that existing tax provisions concerning public purpose (i.e., non-IDB) bond refundings and arbitrage earnings continue being applied to bonds issued for public purpose infrastructure facilities.

Provisions in the Tax Proposal would restrict the physical infrastructure uses that might be made of existing resources but are blocked by existing bond covenants. The arbitrage requirements are not workable, unnecessarily raise the cost of borrowing to issuers and assume a degree of prescience in projecting cash flows that is not feasible.

The CHAIRMAN. Mr. Giglio and Senator Domenici, let me ask you this: Is there any purpose for which tax-free municipal bonds should not be allowed to be used? If a local government determines it is in its interest, whether it is economic development, or transportation, should the Federal Government's position be at your call?

Mr. GIGLIO. No, I don't agree with that, Senator. I think there has been a series of studies that have indicated that there have been some abusive practices. I think that some major policy issues arise when you find yourself in the situation where a facility or a private business has financed a facility using tax-exempt bonds in the marketplace and finds themselves competing with sort of an unfair advantage, competitive advantage, with somebody who has financed that same facility through the availability of taxable financing. I think that engenders, that creates, an unfair competitive advantage.

The CHAIRMAN. Well, isn't that true of almost all industrial development bonds?

Mr. GIGLIO. I don't believe that's true of all industrial development bonds, Senator, because I think you have got to look at the question of not so much use, which is ambiguously defined in the Treasury's proposals, but public benefit. IDB's are used for financing resource recovery projects. Admittedly there is private ownership, but that clearly benefits the entire economy and does protect and promote the environment.

Now, I mean one could come up with a series of elaborate rules on making a distinction, but I don't think that the use issue is the proper criterion.

The CHAIRMAN. Doesn't just attracting a factory that produces 200 jobs benefit the economy?

Mr. GIGLIO. Yes, it does.

The CHAIRMAN. Is that a public purpose?

Mr. GIGLIO. Yes, I believe it is a public benefit and it increases the gross regional product. Yes, sir.

The CHAIRMAN. Well, then, I'll come back. What then would not be a legitimate public purpose? If it is legitimate using bonds to subsidize a business to come to an area because it will produce jobs, give me some examples of what isn't legitimate.

Mr. GIGLIO. Well, it is not legitimate when there are other sources of financing that are available through either a private-sector entity or a public-sector entity.

The CHAIRMAN. You lost me there.

Mr. GIGLIO. Well, I think it has been demonstrated in some of the studies, that where major corporations have available alternative sources of capital and still insist on tapping into the tax-exempt market, that may be creating problems for other issuers in that region who want to access that same marketplace, because there is an alternative form of capital available to them.

The CHAIRMAN. In each case the Treasury, then, should look at these and say, "Is the business that is being attracted, does it have some other source of capital; therefore, this bond should not be exempt?"

Mr. GIGLIO. Well, I think that one criterion might be to look at the alternative forms of capital available. But I don't believe that by looking at a use issue, that should be the sole criterion for determining whether or not it is valid.

The CHAIRMAN. Well, then, to come back to my original question, I find it very difficult to think, when they are attracting the business—and you said that is a legitimate use: 200 jobs is an economic benefit to the town—if we are not going to look at the use but are going to attempt to look at the business that is attracted and say, "Does this business have alternative sources of financing?" Ironically, for businesses in the identical line of business, one may have access to financing and one may not, I don't know if that is the kind of distinction you are making.

Mr. GIGLIO. Well, Senator, I think it is fair to say that we are not talking about infrastructure financing. Most infrastucture projects have not been financed through the use of industrial development bonds, which you seem to be focusing on right now. Most infrastructure projects in this country have been financed either through the issuance of revenue bonds or general obligation bonds.

What is happening, though, under the Treasury proposal is that by repealing the tax exemption for nongovernmental bonds, and by saying that the test, whether it is an IDB or a general obligation or a revenue bond, is a question of use really profoundly alters adversely the ability of State and local governments to finance infrastructure projects.

We are not talking so much about motels or factories.

The CHAIRMAN. Give me an example of what in your mind ought to be an illegitimate use of a bond—I don't care if it is a general obligation bond or a revenue bond—by a local government.

Mr. GIGLIO. Well, one that is used just purely for financing, that clearly has no economic benefit, that no jobs are created or that there is a minimum amount of jobs created and has no economic benefits to the economy.

The CHAIRMAN. In whose judgment? I mean, why would the State issue it if there is no economic benefit?

Mr. GIGLIO. Well, the States are making a judgment based now—taking it into the IDB area—based upon the volume caps that were established in last year's tax deficit reduction bill.

The CHAIRMAN. Senator Domenici.

Senator DOMENICI. Mr. Chairman, what we are concerned about, and we will go into much more detail, are definitions which attempt to make public things—sewerplants—to make them private because it has one big customer. And consequently, with the definitions of the bill before you, you may not be able to finance that as a public facility.

We do not have enough money to build infrastructure and we are not going to have—Senator Chafee knows better than anyone, that in the area of sewageplants, as part of our national cleanup that we lack funds. I mean, we put a cap on our expenditures that don't come close to what is actually going to be needed. And we say for the next 8 or 9 years, "That's all there is." You've got to find some other ways to do it, and we very much want to share information so we don't make it worse with the new Tax Code on that kind of problem.

The CHAIRMAN. Senator Chafee.

Senator CHAFEE. Thank you, Mr. Chairman.

I think it is splendid that Senator Domenici has taken the time to come here, with all the demands on his energies and schedule.

I would like to ask Mr. Giglio: On page 4 of your statement you say that, put simply, highways and roads will go unbuilt and unrepaired; new airports will not be built or will be built more slowly and more expensively; upgrading of sewer and water systems will cost more and take longer to complete.

Somehow I get the impression that before we had an elaborate Internal Revenue Code nothing happened in this country. I don't mean to be facetious, but seriously, if one had come to this Congress in 1935, when certainly liberalism was at its height as far as Federal programs went, and had suggested that the Federal Government will build wastewater treatment plants for every city and State in the Nation, or try to do so, people would say, "No; that is a local responsibility."

What we are trying to do here in this so-called tax reform effort is to reduce the tax rates. Now, the theory is if we reduce the tax rates then local entities, if they so choose, can tax the people and build what they feel is important, whether it is a wastewater treatment plant, or whether it is a reservoir, or an airport, or whatever it is.

And yet, it seems to me the philosophy you are saying is, by making these changes in the code nothing will happen, things won't get done. I have great trouble believing that.

Mr. GIGLIO. I think, Senator, what was a manageable crisis in terms of looking at funding shortfalls, just with respect to the infrastructure services—we are basically talking about those systems that I think most of would agree are the underpinnings of the economy; we are talking about mass transit, bridges, tunnels, and so forth. But I think it was manageable because there were resources available, not just with respect to the tax-exempt bond market but also looking at correcting some pricing policies that seem to afflict the public sector; that is to say that user fees or whatever the public price it, has been artificially subsidized.

The State of Connecticut, your neighboring State, is a good example. They embarked on a major highway program in response to the collapse of the Miamus Bridge. They put together a 10-year financing program, $5.6 billion. It was a capital approach to a capital problem. How was that financed? That was financed through the legislature passing a series of pricing increases or user fee increases, but also by giving them access to the capital market. But they put in place a 10-year program to be able to deal with the $5.6 billion problem in an intelligent way, using a combination of a steady, dependable source of capital, and a steady, dependable revenue stream. And they matched it up and got access to the market at a reasonable cost.

I think if the State of Connecticut had to embark on that program in the face of Treasury II, that program would be measurably and markedly different, particularly with respect to user fees and public prices.

When you start looking at the wastewater treatment requirements, whether it is in your home State or my home State of New Jersey, we are talking about trying to comply with federally mandated standards in funding shortfalls of $800 million. And how are you going to finance it when you look at absolute reductions in public dollars, changes in funding formulas, and the one optimistic note being the ability to convert grants into a loan program to try to achieve leverage? Part of the way you achieve leverage is not only by converting grants into loans but also by keeping in place certain economic incentives, albeit through the Tax Code, that would attract private vendors, to be able to put equity into wastewater treatment plants. You can't have it both ways in terms of tradeoffs.

Senator **Domenici**. Mr. Chairman, could I excuse myself and you continue? I have a 10 o'clock commitment.

The **Chairman**. Yes.

Senator **Domenici**. Let me just comment, Senator Chafee. I think clearly you have to weigh those kinds of tradeoffs as part of this bill in relation to the question you asked. But I have serious doubts whether our cities would have built what they built, even in the early days, the good old days, without munitipal bonds and without that tax exemption. It was a national commitment to a pool of money with a very, very broad, general good in mind. I don't think anybody is questioning that they are getting less relevant, because we have got too many exceptions and exemptions; but you wouldn't have built your jails and city halls and libraries but for the nontaxability of interest on municipal bonds. And they paid for them locally. I mean, I was there; you bonded them, but you were able to afford them because the interest rate was very low, for 30 years. That's how you built your cities.

Senator **Chafee**. Well, I don't think anybody, at least so far—later on we are going to get into possibly doing away with the tax treatment of general obligation bonds. But in my thesis, it was that, yes, we were going to have general obligation bonds.

Senator **Domenici**. Oh, I understand.

Senator **Chafee**. But what bothers me here is sort of the philosophy we are working on that we can't do away with any of these things because nothing will get done. The entire New York subway system was built without a nickel of Federal help. Things do get done without the Federal Government, without the Tax Code twisting things around to make it possible if indeed we can have lower rates. And absent that, clearly it would be self-defeating to get rid of some of these ingenious financing proposals such as you have worked on in Connecticut or New Jersey, wherever it might be.

I notice my time is up, Mr. Chairman. Those were the points I wanted to make.

The **Chairman**. Senator Bentsen.

Senator **Bentsen**. Thank you, Mr. Chairman.

I serve on the Environmental and Public Works Committee along with Senator Chafee and Senator Domenici. There is no question but what the infrastructure of this country is in real trouble and has been neglected for far too long.

I agree with Senator Chafee. I don't know anyone who is quarreling with the idea, at least at the moment, of the tax exemption for traditional municipal bonds. It takes care of the sewer system and the roads and bridges. They need all those advantages.

But what we are talking about is taking away at the moment the tax exemption for private purpose bonds. And as one of the witnesses says in his testimony, that is finally the bottom line, anyway, in every State. There is not any serious competitive advantage for one State over another, so why should we give it at all? Why should we give that kind of an advantage to the private sector? It seems to me that that is what is being done. And to say, "Well, then it won't be built," it seems to me that all they are trying to save is two or three points—and that is important and I understand the economics of that—but at the same time with this incredible explosion in these bonds, in 1976 some $9 billion of them that were issued, and in 1983 that figure jumped to $57 billion. You know, it is going right on through the roof, more and more, as fellows in your business find more ways to create them and bring them about.

I admire your ingenuity, but I think we have to put some limitations on it. And the problem is going to be—the administration talking about something in excess of 1 percent, as I understand it, use for the private sector, and that's pretty tough—that at some point you have to draw the line.

Finally, I find myself somewhat in sympathy with trying to put a limitation on these.

Mr. GIGLIO. May I respond to that, Senator?

Senator BENTSEN. Yes; I wanted you to.

Mr. GIGLIO. I am not here to comment on the issue of industrial development bonds for commercial use or for housing, multifamily housing, or any of those issues. I am trying to focus on infrastructure issues. And when you look at the classic example of resource recovery projects that typically you have been able to attract—most municipalities and State and local governments have been able to attract—the private sector to come in either to construct, design, own, or operate these projects on a successful basis since 1975, it is because the economic incentive is there when one looks at the combination of the availability of tax-exempt financing for resource recovery projects, the availability of investment tax credits, and the ACRS.

Now, when one starts to look at the numbers of what the tipping fees or the disposable fees would be for a municipality if you did not have the private sector, one is talking about an increase in tipping fees that range from 50 to 100 percent.

It seems to me that there is another issue here, that given the recent technology—the first resource recovery project in this country was done in 1975 in Saugus, MA, and I think there have been about 50 projects done since there—there is clearly an extraordinary need. What this program does, what Treasury II does, is put the burden back on the municipality if the project experiences cost overruns or if the resource recovery plant doesn't work. That seems to me to undermine the whole notion of privatization.

What I am arguing is that, when one looks at whether it is resource recovery or wastewater treatment, that one ought to make available and continue to make available to a State or local government the opportunity to tap into the tax-exempt market and also to still make available the availability of ITC and the accelerated cost recovery system.

The CHAIRMAN. I have no more questions.

Mr. GIGLIO. Thank you, Senator.

The **Chairman**. Thank you very much. We appreciate your coming.

Now we will take Senator D'Amato. Al, thank you very much for waiting; we appreciate it.

STATEMENT BY HON. ALFONSE M. D'AMATO, A U.S. SENATOR FROM THE STATE OF NEW YORK

Senator **D'Amato**. Mr. Chairman, thank you for giving me the opportunity to share some thoughts with the committee on the Treasury's 1-percent proposal limitation on bonds.

I am going to ask that my full statement be accepted so that I could save some time.

The **Chairman**. Without objection.

Senator **D'Amato**. Let me go right into what even in my statement I think is somewhat obscured, because we deal initially in my statement with the fact that there will be an impact in regard to municipalities and their ability to finance the infrastructure needs. This is a result of the loss of the deductibility of State and local taxes. The pressure to raise taxes, therefore, to finance general obligation bonds is going to be much, much more difficult.

Having said that, I think there is a common misconception that the Treasury proposal on tax-exempt bonds impacts more than just IDB's. The fact of the matter is that Treasury has taken aim at the fundamental operations of cities and States. The Treasury proposes that tax-exemption be denied if 1 percent or more of the bond proceeds are used by a private entity.

Now, the effect is not just IDB's, but it will definitely impact general obligation bonds. Let me give you, if I might, several examples, examples that exist today.

For example, the city of Atlanta is planning to issue a $14 million general obligation bond to fix up their zoo. The zoo is owned by the city, but it is managed privately. Since much of the proceeds of the general obligation bond will go for the private managers, the bonds will not be tax-exempt. To qualify for tax-exempt financing under the 1-percent rule, the city will have to manage the zoo themselves. Ridiculous. Absolutely ridiculous.

The county of Westchester, NY. It owns the Westchester Airport. The airport is managed by Pan American. What does the county know about managing an airport? What does Treasury know about what local governments go through? Nothing. And so under this proposal the county of Westchester has got to go into managing an airport.

This is not to mention building garbage plants that are going to deal with the environmental considerations that we never thought about 100 years ago, or 75 years ago, or 50 years ago, or 25 years ago.

I wish Senator Bentsen and Senator Chafee were here so we could address the fact that today the environmental needs demand that there be a sophistication and a level that most municipalities simply do not have. If you are going to have them build solid waste treatment plants, I want to tell you instead of a plant costing $300 million it is going to cost $600 to $700 million. Instead of it being built in 3 or 4 years, it will be 10 years, if it is ever built. Instead of the cost to the taxpayer being held down, it will be much higher. So what you have is pertetual Government inefficiency and ineffectiveness.

Now, why shouldn't there be the merger of public purpose and private operation?

That leads me to one other area. Do I feel strongly about it? I do. Because, I see Treasury without the slightest idea about what it takes to manage a town, a city, or a village. We put on them all these various rules and regulations in terms of how they are going to do it, and we say, "We are going to give you the responsibility; you finance it," and then we undercut the pinnings for them to do this.

I feel that instead of the issue being public ownership, that's a great way in terms of determining if something should be tax-exempt financing, because we want to encourage privatization where it makes sense, we should look at the activities that serve the general public—the activities. Obviously, the disposal of solid waste is an activity that covers that. The fact that there may be 10, 15, or 20 percent private operation, et cetera, the taking in of garbage that comes from outside that individual municipality that makes it more cost effective and efficient, should not disqualify it.

And as the young man was attempting to say over here, if we disallow the use of IDB's in the construction of a solid waste facility, I am going to suggest that you will find that the tip fee to be double to local government. That it is going to cost the Treasury much more, because they don't make any money when general obligations are floated by the cities. Those bond issues are going to be much higher if the municipalities do it, they will have to raise $400 million instead of $200 million. The taxpayer at the local level will have to pay, the Treasury hasn't gained anything, but someone can say, "Oh, you see, we have saved. We have saved the Treasury money because we didn't float IDB's in the construction of this facility."

So, Mr. Chairman, I hope we focus in on the issue that seems to, I think—even if it escaped my wonderful planner and drafter over here, and legal beagle, who wanted to bring in deductibility of State and local taxes. He put that in, and then I look at it and say, "But, my God, you know, you really touched on something here." That's Robin Solomon; let's give him credit for doing it. That is the fact that tax exemption denied by the 1-percent rule goes right after the general obligation bonds as it relates to local municipalities. Treasury great ideologues, but I wouldn't want to depend on them in terms of running the cities and the towns and the counties.

Thank you, Mr. Chairman, for giving me the opportunity of making this thought known to you. I ask you to focus in on it, and I know you will. And my senior Senator from New York is here. I think he knows we have got the city of New York itself which is looking to build nine resource recovery plants. And if they had to do it themselves it would never, never, never take place, and the cost would just be two-three-four-five times as much, and the Treasury wouldn't gain one single penny for it.

[Senator's D'Amato's written testimony follows:]

STATEMENT OF SENATOR ALFONSE D'AMATO

Mr. Chairman, I appreciate the opportunity to testify before your committee on the Treasury tax reform proposals concerning industrial development bonds.

First, I want to emphasize my belief that it would be a mistake to look at the individual provisions of the treasury plan by themselves. Tax reform in toto will have a serious impact on State and local finance beyond those provisions that effect tax-exempt bonds.

The Treasury plan will force State and local governments to issue more general obligation bonds. However, while the need to issue more bonds will rise, the tax bases supporting these bonds will be greatly reduced.

This will be the direct result of repeal of the deduction for State and local taxes. Municipal bonds are supported by a jurisdiction's tax base. Repeal of the State and local tax deduction will force a drop in taxes, thus reducing the tax base.

How will a city or State issue more bonds supported by a weaker credit base? This scissors effect will either make it impossible for community needs to be met or will cause taxes to rise.

Second, I would like to dispell a common misconception. The Treasury proposal on tax-exempt bonds impacts more than just IDB's. Treasury has taken aim at the fundamental operations of cities and States.

Treasury proposes that tax exemption be denied if 1% or more of the bond proceeds are used by a private entity. This effects not just IDB's, but many general obligation bonds.

For instance, let's take a city that floats a $10 million general obligation bond to fund a publicly owned resource recovery facility. This city uses $110,000, or 1.1% of the proceeds, to contract out for private garbage pick-up. Of course, the purpose of a resource recovery facility is to dispose of garbage.

In this example, the general obligation bond would lose its tax-exempt status just because the refuse pick-up was done by a private business. So what will the city do in response to this problem? The city will have to own and operate its own garbage collection service.

Treasury's 1% rule will force State and local governments to take on more services and compete with the private sector. Something as simple and easy as garbage collection will be done by Government, instead of by small businessmen.

Why does Treasury want to do this? They think they will raise money. But the example I gave saves no money for the Federal Government. General obligation bonds will still be issued; garbage collection will just be done publicly to conform with tax law.

Moreover, public garbage collection means a loss of tax dollars because private collectors pay taxes. Treasury's plan would actually lose revenue by encouraging more Government ownership.

Local governments do not take on the construction of a resource recovery facility just for the fun of it. Local Governments have no choice but to build the facility. Without IDBs, local officials will have no choice but to float general obligation bonds.

Treasury would force more public ownership of operations that can be taken on by the private sector. More importantly, Treasury would do this and force a revenue loss for the Federal Government. General obligation bonds are tax-exempt, just like IDBs, but public ownership loses revenue compared to private ownership.

When confronted with this, Treasury says that municipal facilities will be built privately anyway because of other tax enducements. This is the so-called "double dipping" argument associated with the use of IDBs.

This makes no sense under the Treasury tax plan. Treasury would repeal the investment tax credit and lengthen real property depreciation from 18 years to 28 years.

What incentives will exist for the private sector to become involved in municipal services such as resources recovery? Virtually none. And what does Treasury accomplish through its 1% rule? A revenue loss!

Mr. Chairman, the 1% rule must be changed. It will exacerbate the deficit and will encourage more and bigger State and local governments. An alternative must be found. I would enjoy working with the committee to find such an alternative.

Thank you, Mr. Chairman.

The **CHAIRMAN**. Over the years the definition of what a public purpose is has become more amorphous. Seventy-five years ago, transit garbage collections were not public purposes.

Let me ask you this, Al: What today is not a public purpose? Is it perfectly legitimate to use the money straight out to attempt to entice a business to move to New York City that is otherwise located in Detroit?

Senator D'AMATO. Two different issues.

The CHAIRMAN. I know that.

Senator D'AMATO. That is not a public purpose. No.

The CHAIRMAN. Who determines what a public purpose is?

Senator D'AMATO. That is not a public purpose. I have probably been one of the foremost, along with my good friend Senator Stennis, in defending small-issue IDB's, but that is private-sector activity.

The CHAIRMAN. I don't mean small issue; I am talking about big issue if necessary.

Senator D'AMATO. Well, big issue as well, but that is clearly private sector—clearly private sector.

The CHAIRMAN. All right. Now, start moving down the spectrum. When does it become a public-sector responsibility, or at least a sufficient obligation that you can count it as a public-sector obligation for purposes of the bonds?

Senator D'AMATO. You have to look at the activity. If the activity is one associated with public purpose, such as transportation, I think generally we can say, as you pointed out years ago and as Senator Chafee pointed out years ago, it was private. Well, I think that we have recognized that the private sector, for whatever reason, could not maintain that level of transportation, and that government over a period of time has begun to fuel and develop public necessities for elderly people, for people without great financial means who could not afford, let's say, a private department of transportation.

So you have to look at the service that is engendered—disposal of solid waste. We get into a closer look at prisons, prison construction. Does it serve the general public? I would suggest to you that simply because a prison might be built by the private sector, and even owned by a private company, and maybe, depending upon if a State wanted to, contracted out for private operation, that nonetheless there was that public-sector service.

The CHAIRMAN. Well, Mr. Giglio says attracting a business that provided 200 jobs is a public purpose.

Senator D'AMATO. I have to disagree with him, respectfully, on that. Does this represent a substantial retreat from my previous positions on the issue? No, but you cannot mix the two. Creating jobs in the private sector you cannot say meets the definition.

As a matter of fact, I have been asking some of the people in the area to come up with definitions that could reasonably be put forth. And I think it really comes down to, "Does the activity really serve the general public?" Solid waste facilities, prison facilities, transportation facilities, or water facilities? I think they do.

And I don't think the hangup should be, or the rule should be, "public ownership." As a matter of fact, I think if we can save money and encourage the kind of local activity that we say we want cities to do, then let them have that public ownership.

The CHAIRMAN. Senator Chafee.

Senator CHAFEE. Thank you, Mr. Chairman.

I think that Senator D'Amato has performed a service here in pointing out to us the problems that would arise with a municipality if over 1 percent of the general obligation bonds were used for private purposes. I think his resource recovery facility illustration is a good one, and I am glad you came and pointed that out to us.

I don't have any other questions, Mr. Chairman.

The CHAIRMAN. Senator Moynihan.

Senator MOYNIHAN. I want to welcome my colleague and friend again to the committee and just very much endorse what he has said and Senator Chafee's response. I think this is something much larger than the question of revenue and the question of financing of public purposes; it is a question of an approach to government.

I guess if I could make a general point, it is that there has been a kind of cycle that we see over our long history—some—of matters beginning as private activities then becoming public, and then over a long cycle beginning to become private again. Fire departments. The military. We have, up in Water Bleeks, in our data a complete arsenal which is a cannon for every war in the United States since 1812. But in the main, the Armed Forces don't build their own cannons; they contract out. And one of the big events—Senator D'Amato is the authority on local government; he ran a local government the size of most States—is the beginning of privatization. There is a call around Washington right now which is, "Say, listen, the town of Hempstead," or a county in Nassau, or whatever, "isn't really good at putting up a $1 billion machine called resource recovery, but there are people around here who know how to build that billion-dollar machine. We will finance it, they will run it," or Westchester making the judgment, "Let Pan Am run an airport; they know how to do it, and do it just as well." This would be a fundamental block to that movement, would it not?

Senator D'AMATO. Absolutely, Senator, without doubt. And there is that movement which recognizes in the long run efficiency, cost effectiveness.

Senator MOYNIHAN. Yes. You are doing it because it is cheaper that way.

Senator D'AMATO. Cheaper, more effective, more efficient.

Senator MOYNIHAN. And so a result of making this impossible, you would get more expensive government.

Senator D'AMATO. Absolutely. Inevitably, in my conclusion, it will cost the municipality more because you will double the cost of any major facility.

Senator MOYNIHAN. You would double the cost of any major facility. This is a proposal to increase the cost of government.

Senator D'AMATO. And you will have to sell more general obligation bonds.

Senator MOYNIHAN. Which necessarily raises the price just of the bonds themselves.

Senator D'AMATO. Sure. Throughout the Nation you are going to have that kind of impact.

Senator MOYNIHAN. I think that is an extraordinarily important point. If you care about this idea of how do you privatize activities, at which government in fact is not very good, like building a billion-dollar machine.

Senator D'AMATO. There are close questions, and I understand we will never avoid the close questions. I don't think that anyone would disagree with the operation of a municipal solid waste disposal plant, except some people down at Treasury. That is a public service and a public purpose, and we agree, particularly given the problems with the landfills and the pollution of the drinking water and the offshore waters, et cetera.

But there are close questions. For example, the municipality that operates the public docking facility. I am familiar with that; we run a marina in our town. That is a grey area. I wouldn't attempt to answer it here, but it crosses over the bounds and when you might say it is private. Then again, if you are a community on the waters, and you are determined that you want to make this as part of the total environment, it becomes a question.

Senator MOYNIHAN. But it is not a question where you really strain the capacity of local government. You can build docks.

Senator D'AMATO. That's correct.

Senator MOYNIHAN. But there are a lot of things that are ordained by Federal law. I am thinking right now of a treatment plant on the North River in our State that is coming in at $1.1 billion. That is a hell of a big machine. And there are engineering firms that will just make that machine better for you. And there is no reason a local government should have the capacity to do it; that is not what it is good at.

Senator D'AMATO. The fact is, in our State and in most States you would have to bid out four separate contracts. All of the contractors wind up suing each other, and the municipality always winds up bearing the burden, and it doubles and triples the cost.

Senator MOYNIHAN. Thank you. I just think if we want to put an end to the direction of privatization of government activities, this is a good way to do it. But still, I think Senator D'Amato has made the case.

The CHAIRMAN. Senator Heinz.

Senator HEINZ. Mr. Chairman, I came in in the middle of Senator D'Amato's testimony and questions, but I do want to observe that, as some members have touched on, what he has proposed for us as a definition of how we should look at these eligible activities is the focus on not the sponsor per se but the activity per se. That means, of necessity, that we would be writing—and indeed, I hope we do—what will be a dynamic definition. Public purpose activities change, evolve, over time.

Senator Moynihan, our historian of record on the committee, has spoken to that subject. And while I suspect there will be some who will fault us for not nailing down with great precision exactly who can do what, when, and where; nonetheless, I think we would be not meeting our responsibility to the public were we so to do. And therefore, the definition of a "public purpose activity" is the right approach. And I hope that the committee will give full weight to Senator D'Amato's recommendations in that regard.

None of us should be under the illusion that drafting the right definition is going to be easy; that's the rub, as they would say. But I am confident that we can do it. And I would hope that our definition, when finally agreed upon, is flexible enough so it is a dynamic definition.

I just want to commend my friend and colleague Senator D'Amato for making another of his numerous appearances. I have already seen him at one today already.

I have no further questions.

The CHAIRMAN. Senator Long.

Senator LONG. Thank you for your statement, Senator D'Amato. I think you and I see this matter a great deal the same way. When the Federal Government seeks to solve its problems by taxing the interest from State obligations, it, to a large extent, is taxing the State government. It is a very poor policy, given our structure of government, for one level of government to try to solve its problems by taxing the other levels of government. It is a beggar-thy-neighbor policy to try to solve your problems by dumping them off on the other fellow.

I have worked with you on this matter, and I hope to work with you some more trying to prove to people that it is a mistake for this Government to tax State and local governments.

The Federal Government is taking extreme measures to see that the State and local governments do not do the same thing to the Federal Government that they would propose to do to them. At some point people ought to wake up and realize that it is evil to tax the essential functions of another level of government. That is what you are doing when you are taxing the interest on State and local bonds. I am talking about the bonds for the essential purposes of State and local governments.

I hope to support your position on that. Maybe if we just stay at it, eventually we will get quite a few others to see the light.

Thank you.

The CHAIRMAN. Senator Pryor.

Senator PRYOR. Thank you, Mr. Chairman.

I have just one question for Senator D'Amato, and I am sorry I got in in the middle of your statement. But we made some reforms in the industrial development bond area in 1982, and I think again in 1984, and I guess it was in 1984 we implemented a $150-per-person cap, as I recall, on the totality of the amount of bond issues. I wonder if those reforms that we have taken in 1982 and 1984 have been sufficient in your mind to correct whatever abuses might have been before these reforms were implemented by the Congress?

Senator D'AMATO. Senator Pryor, I think we certainly made great progress in addressing legitimate questions with respect to the utilization of IDB's. In funding, for example we determined those who really did not have need for these funds. I think we moved in the right direction with respect to a cap and allowing some latitude with State and local governments. And I think there may be, as interest rates hopefully continue to go down, it might provide us with the impetus to even bring about some additional constraints with respect to utilization of the IDB's for the small issuer.

For example, it may be distressed areas, as it relates to certain kinds of private activities, perhaps we should confine it to those areas.

Of course, I always feel that if you have an area that is marginal, hasn't reached what you call "a distressed area," you may be doing it a disservice in waiting for it to finally reach the blighted stage before you say it qualifies for help; because in some of these areas it is difficult to attract private capital. Now, is that a public purpose? These are close questions. Should we want to attempt to avoid the kind of economic stress that then calls for much greater investments?

I think we went a long way in dealing with some of the classic abuses that were cited. For example, the opening up of the big liquor stores, and the dirty book stores, and those kinds of examples that were used by people who are aghast at the use of IDB's where maybe there was not a necessity. And I think that small entrepreneurs should still be recognized in the day of high interest rates, although they are not nearly as high as they once were. But I think that still is a legitimate function on the private side to be aware of.

Senator **Pryor**. Senator, just as one member of the committee, I thank you. We all appreciate you coming today, especially with your background and expertise in the matters and the affairs of local government, and we value your opinion very much.

Mr. Chairman, in closing—I have no other questions—I would like also to commend at this time Senator Stennis of Mississippi. I did not get to hear his testimony this morning, but I have had the privilege of reading Senator Stennis' testimony. And I can say that what has happened in the State of Mississippi is somewhat parallel to what has happened in the State of Arkansas in the creation of jobs and the encouragement of private initiative there, and the creation of opportunities for our people in relatively poor States to let's say better their quality of life. And I commend Senator Stennis for his statement. And I share his plea that we not totally wipe this program out; "if it needs reform, then let's reform it," I think Senator Stennis stated, and I certainly back that plea and hope that we can find some answer to this issue that is before the committee this morning.

Thank you, Mr. Chairman.

The **Chairman**. Thank you, Senator.

Senator D'Amato, thank you very much for coming in and waiting patiently to get on.

Senator **D'Amato**. Thank you, Mr. Chairman.

The **Chairman**. Next we will have a panel of four people on the issue of, "Should bonds for nongovernmental uses be taxed?" We are going to let the four witnesses speak con-pro-con-pro and interrupt each other if they want, limiting their statements to 5 minutes. And we will ask questions, interrupting each other if we want. It is a format we followed last week, and it worked pretty well.

So we will take Dr. Joseph Minarik, Dr. Harvey Galper, James J. Hughes, and Dr. Gary Hufbauer. The agreed order of speaking is Dr. Minarik, Mr. Hughes, Dr. Galper, and Dr. Hufbauer.

Dr. Minarik, go right ahead.

STATEMENT BY DR. JOSEPH J. MINARIK, SENIOR RESEARCH ASSOCIATE, THE URBAN INSTITUTE, WASHINGTON, DC

Dr. **Minarik**. While the tax exemption of interest on public-purpose State and local bonds has been a part of the Federal income tax system since its creation, the use of tax exempts to finance private purpose investment is a comparatively recent phenomenon. In fact, the growth of private-purpose tax-exempt financing has been so rapid as to be almost revolutionary.

In 1975, new issues of private-purpose tax exempts were just $8.9 billion or 29.2 percent of all tax-exempt issues. By 1983, only 8 years later, private-purpose issues increased more than sixfold to $57.1 billion. These private-purpose bonds dominated the market, constituting 61.2 percent of all new tax exempts.

Most economists agree that this explosion of private-purpose tax exempts is dangerous. There are two main reasons:

Private-purpose tax-exempt bonds are bad for the economy. Like all interventions into the market process, tax exemptions for private-purpose bonds tend to reduce economic efficiency. Only certain kinds of investments are amenable to tax-exempt financing, and because the tax exemption makes those investments cheaper we tend to overinvest in them. The additional investment in tax-exempt projects does not add to jobs or incomes in the economy as a whole. The investment funds used in those projects must be bid away from other activities in other locations.

Basic economic analysis suggests that a project that needs a tax exemption to compete in the marketplace will not add as much to productivity and growth as unsubsidized investments that it displaces; and the tax subsidy for any investments that can compete in the market is just a windfall gain for the investor.

Furthermore, governmental entities and businesses that are best at playing the game of obtaining Government financing have an advantage. It is far from clear that mastery of the financing process is a test of economic merit, and so this political hurdle may decrease economic welfare.

Private-purpose tax-exempt financing erodes the Federal income tax base. As more and more new private investment is moved under the umbrella of tax-exempt financing, it leaves the tax base smaller relative to what it otherwise would be. This forces up the tax rates on non-exempt income. The higher tax rates discourage productive activity and encourage avoidance and evasion and further tax-exempt financing, renewing the cycle. The erosion of the tax base continues until the bonds mature.

Finally, private-purpose tax-exempt financing is an inefficient subsidy. Because tax-exempt bonds must compete with taxable bonds of equal risk, they must offer the same after-tax return to the marginal or last buyer of tax exempts. As tax exempts take up an increasing share of the market, they must appeal to more buyers—that is, buyers with lower marginal tax rates. As the tax exempts are forced to appeal to buyers with lower tax rates, their yields must increase. For example, if a tax exempt is to compete with a 10-percent taxable security, for a buyer in the 50-percent bracket the tax exempt must yield 5 percent. But if tax exempts become so plentiful that they must be sold to people in the 25-percent bracket as well, the tax-exempt yield must be 7.5 percent.

This increase in rates provides a windfall to taxpayers in brackets above 25 percent, a Federal tax subsidy that never reaches the States and localities. Still more of the Federal subsidy goes to bond counsel and securities dealers rather than to Government.

Private-purpose tax-exempt bonds are bad for States and localities as well. Private-purpose tax exempts are not the boon to States and localities that they are sometimes made out to be. Tax-exempt financing cannot be an effective incentive to investment in a distressed locality if other localities within and without the same State can offer the same financing. The tax exemption rapidly becomes a baseline condition to the investor, leaving other considerations to determine the locational choice.

Tax-exempt financing is worse than ineffective, however; it is positively harmful. As they have increased in supply, all tax-exempt securities including public-purpose bonds have had to offer higher yields. This increases the cost for governments trying to perform traditional public functions as well as for sellers of private-purpose tax exempts.

Obviously, the boom in private-purpose bonds is the major cause of the erosion of the rate differential between taxable and tax-exempt bonds. This process is self destructive. A State or locality which does not float enough securities of its own to influence rates has every incentive to maximize its use of tax exempts to compete with other localities. But if every State and locality follows its self interest in this way, interest rates are driven up. There is never any incentive for individual States or localities to get off of this merry-go-round; the Federal Government must enforce the collective self interest of the States and local governments.

Just as States and localities have no reason to hold back on issuing tax exempts, so businesses have no reason to refuse tax-exempt financing. On the contrary, businesses can play one government against another to obtain exempt financing in a bidding war over business location. Again, only the Federal Government has the interest and the influence to restrain this self-destructive process.

Thus, it is incumbent on the Federal Government to stop the escalation of private-purpose tax-exempt financing. The Federal tax base would be restored, thereby helping to control the deficit and streamline the tax system. The tax-reform process is the perfect occasion to take this important step.

The CHAIRMAN. Thank you.

Mr. Hughes.

[Dr. Minarik's written testimony follows:]

PRIVATE-PURPOSE TAX-EXEMPT BONDS

Statement of

Joseph J. Minarik
Senior Research Associate
The Urban Institute

Before the Senate Committee on Finance

June 25, 1985

While the tax exemption of interest on public-purpose state and local bonds has been a part of the federal income tax system since its creation, the use of tax-exempts to finance private-purpose investment is a comparatively recent phenomenon. In fact, the growth of private-purpose tax-exempt financing has been so rapid as to be almost revolutionary. In 1975, new issues of private-purpose tax exempts were just $8.9 billion, or 29.2 percent of all tax-exempt issues. By 1983, only eight years later, private-purpose issues increased more that six fold, to $57.1 billion. These private-purpose bonds dominated the market, constituting 61.2 percent of all new tax exempts.

Most economists agree that this explosion of private-purpose tax exempts is dangerous. There are two main reasons.

Private-purpose tax-exempt bonds are bad for the economy. Like all interventions into the market process, tax exemptions for private-purpose bonds tend to reduce economic efficiency. Only certain kinds of investments are amenable to tax-exempt financing, and because the tax exemption makes those investments cheaper, we tend to overinvest in them. The additional investment in tax-exempt projects does not add to jobs or incomes in the economy as a whole; the investment funds used in those projects must be bid away from other activities in other locations. Basic economic analysis suggests that a project that needs a tax exemption to compete in the marketplace will not add as much to productivity and growth as the unsubsidized investments that it displaces. And the tax subsidy for any investments that could compete in the market is just a windfall gain for the investor.

Furthermore, governmental entities and businesses that are best at "playing the game" of obtaining government financing have an advantage; it is far from clear that mastery of the financing process is a test of economic merit, and so this political hurdle may decrease economic welfare.

Private-purpose tax-exempt financing erodes the federal income tax base. As more and more new private investment is moved under the umbrella of tax-exempt financing, it leaves the tax base smaller relative to what it otherwise would be. This forces up the tax rates on nonexempt income. The higher tax rates discourage productive activity and encourage avoidance and evasion--and further tax-exempt financing, renewing the cycle. The erosion of the tax base continues until the bonds mature.

Finally, private-purpose tax-exempt financing is an inefficient subsidy. Because tax-exempt bonds must compete with taxable bonds of equal risk, they must offer the same after-tax return to the marginal (last) buyer of tax exempts. As tax exempts take up an increasing share of the market, they must appeal to more buyers--that is, buyers with lower marginal tax rates. As the tax exempts are forced to appeal to buyers with lower tax rates, their yields must increase. (For example, if a tax exempt is to compete with a 10 percent taxable security for a buyer in the 50 percent bracket, the tax exempt must yield 5 percent. But if tax exempts become so plentiful that they must be sold to people in the 25 percent bracket as well, the tax exempt yield must be 7.5 percent). This increase in rates provides a windfall to taxpayers in brackets above 25 percent--a federal tax subsidy that never reaches the states and localities. Still more of the federal subsidy goes to bond counsel and securities dealers, rather than to governments.

Private-purpose tax-exempt bonds are bad for states and localities. Private-purpose tax exempts are not the boon to states and localities that they are sometimes made out to be. Tax-exempt financing cannot be an effective incentive to investment in a distressed locality if other localities within and without the same state can offer the same financing. The tax exemption rapidly becomes a baseline condition to the investor, leaving other considerations to determine the locational choice.

Tax-exempt financing is worse than ineffective, however; it is positively harmful. As they have increased in supply, all tax-exempt securities, including public-purpose bonds, have had to offer higher yields. This increases the costs of governments trying to perform traditional public functions, as well as sellers of private-purpose tax exempts. Obviously, the boom in private-purpose bonds is the major cause of the erosion of the rate differential between taxable and tax-exempt bonds.

This process is self-destructive. A state or locality which does not float enough securities of its own to influence interest rates has every incentive to maximize its use of tax exempts to compete with other localities. But if every state and locality follows its self-interest in this way, interest rates are driven up. There is never any incentive for individual states or localities to get off of this merry-go-round; the federal government must enforce the collective self-interest of the state and local governments.

Just as states and localities have no reason to hold back on issuing tax-exempts, so businesses have no reason to refuse tax-exempt financing. On the contrary, businesses can play one government against another to obtain exempt financing in a bidding war over business location. Again, only the federal government has the interest and the influence to restrain this self-destructive process.

Thus, it is incumbent upon the federal government to stop the escalation of private-purpose tax-exempt financing. The federal tax base would be restored, thereby helping to control the deficit and streamline the tax system. The tax reform process is the perfect occasion to take this important step.

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PRIVATE-PURPOSE TAX-EXEMPT BONDS

Private-purpose tax-exempt bonds are bad for the economy. Like all interventions into the market process, tax exemptions for private-purpose bonds tend to reduce economic efficiency. Only certain kinds of investments are amenable to tax-exempt financing, and those investments are so much cheaper that we tend to overinvest in them. Even for those investments that would have been undertaken anyway, there is a windfall. Furthermore, governmental entities and businesses that are best at "playing the game" of obtaining government financing have an advantage; it is far from clear that mastery of the financing process is a test of economic merit, and so this political hurdle may decrease economic welfare.

Private-purpose tax-exempt financing erodes the tax base. As tax-exempt funds are used to support a significant share of new private investment, the base of income subject to tax shrinks relative to what it otherwise would be. This forces up the tax rates on nonexempt income. The higher tax rates discourage productive activity and encourage avoidance and evasion--and further tax-exempt financing, renewing the cycle.

Finally, private-purpose tax-exempt financing is an inefficient subsidy. Because tax-exempt bonds must compete with taxable bonds of equal risk, they must offer the same after-tax return to the marginal (last) buyer of tax-exempts. As tax-exempts take up an increasing share of the market, they must appeal to more buyers--that is, buyers with lower marginal tax rates. As the tax exempts reach down to buyers with lower tax rates, their own interest rates must increase. (For example, if a tax exempt is to compete with a 10 percent taxable security for a buyer in the 50 percent bracket, the tax exempt must yield 5 percent. But if tax exempts become so plentiful that they must be sold to people in the 25 percent bracket as well, the tax exempt yield must be 7.5 percent). This increase in rates provides a windfall to taxpayers in brackets above 25 percent--a federal tax subsidy that never reaches the states and localities.

Private-purpose tax-exempt bonds are bad for states and localities. As they have increased in supply, all tax-exempt securities, including public-purpose bonds, have had to offer higher yields. This increases the costs of governments trying to perform traditional public functions, as well as sellers of private-purpose tax exempts.

This process is self-destructive. A state or locality which does not float enough securities on its own to influence interest rates has every incentive to maximize its use of tax exempts. But if every state and locality follows its self-interest in this way, interest rates are driven up. There is never any incentive for individual states or localities to get off of this merry-go-round; the federal government must enforce the collective self-interest of the state and local governments.

Just as states and localities have no reason to hold back on issuing tax-exempts, so businesses have no reason to refuse tax-exempt financing. On the contrary, businesses can play one government against another to obtain exempt financing in a bidding war over business location. Again, only the federal government has the interest and the influence to restrain this self-destructive process.

STATEMENT BY JAMES J. HUGHES, JR., PRESIDENT, COUNCIL OF INDUSTRIAL DEVELOPMENT BOND ISSUERS, WASHINGTON, DC

Mr. **Hughes**. Mr. Chairman, Senators, good morning.

Thank you for this opportunity to comment on the President's tax plan which has consequences which will be enormous and frightening.

Approximately two-thirds of all projects now eligible to be financed with tax-exempt bonds will lose that well established and well earned right. These investments are at risk because certain ideologues have disparaged financing partnerships between public and private interests for pollution control, student loans, hospitals, housing, and job creation as nongovernmental. But I ask you, what is nongovernmental about investing in tomorrow's brainpower through student loans, promoting educational quality and opportunity for growth of our human resources? I ask you what is nongovernmental about stimulating investments in affordable housing for people of low and moderate means? This has been a fundamental priority of national policy for decades. I ask what is nongovernmental about investing in environmental cleanups? Our urban regions are desparate for solutions to the hazards of chemical waste, so much so that this committee voted last month to expand the authorized use of tax-exempt bonds to address this public imperative.

Yet we now have a proposal which dismisses this challenge of an environmental quality as a nonpublic purpose.

Finally, I ask what is nongovernmental about stimulating investments in economic growth that creates new jobs and greater productivity?

The substantial cost savings inherent in tax refinancing is what the President's tax plan would take away. This usually makes the difference between go and no-go, between jobs and no jobs. It means making available otherwise unaffordable housing, otherwise unobtainable higher education, better health care, and an improved environment. Removing the tax exemption represents a major cost shift from the Federal Government to States and localities. Let's examine how the administration justifies this tax shift.

They assert that nongovernmental borrowing erodes the Federal tax base and forces increases in tax rates on nonexempt income. This latter claim cannot be demonstrated, particularly because at no time during the past 10 years covered by the Treasury's analysis have individual tax rates gone up.

As for Federal revenue loss, Treasury calculations are erroneous; they deny the existence of tax reflows from extra economic activity, and they presume that all private activity-bound investors would alternatively invest their money in a taxable instrument.

Let's look specifically at the reflows in the area that I know best—that of small issue IDB's.

At the New Jersey Economic Development Authority we conducted a study based on a recent fiscal year that indicated, on a national basis, IDB-financed projects generated in excess of $3 billion in total tax receipts for the Federal Government. Additionally, the study indicated that nearly $2 billion was added to State and local government receipts. These findings certainly question the purported revenue losses that some attribute to this program.

On the issue of nongovernmental bonds pushing up interest rates of traditional obligations of State and local governments, virtually all studies minimize this causal effect. Under the small issue IDB program, for example, more than 80 percent of financings are privately placed. Consequently, any effects on the public credit markets are almost negligible. There are differing markets, and we must recognize this fact.

Next, the Treasury asserts that IDB's are anticompetitive and distort the marketplace, which applies a test to this program not applied to virtually any other governmental area. By definition, the Government program or regulation represents an interference in the free market. To carry this argument to its extreme would require us to abandon environmental regulation, farm price supports, et cetera.

Finally, not once in the discussion does the administration even acknowledge the work of so many of you on this committee and many others to reach agreement in 1984 on changes in the tax-exempt bond area. Yet, the administration's analysis of current law does not even mention the volume cap, and their chart of bond volume issuance ends in 1983, the last year before the cap took effect.

I would add that for activities now under the cap, bond volume will be reduced by 33 percent on January 1, 1987.

Consider that financing costs associated with taxable bond alternatives will encourage governments to increase their ownership and operation of many facilities that could be more efficiently run by private companies. Given this incentive, the volume of tax-exempts will not decrease nearly as much as Treasury indicates.

Last week the Joint Economic Committee released its annual national survey of the fiscal health of the Nation's cities. IDB's represented the single most important program in local efforts to promote economic development. A public declaration this week by 11 public interest groups representing Governors, mayors, and State legislators unanimously opposed the tax-exempt bond provisions of the present proposal and showed that the Treasury's "we know what's best for you" attitude is not well received.

If Congress strips this financing power away, I predict that whenever interest rates and unemployment resume their upward march toward some inevitable recession, public clamor will demand affordable capital to build housing, repair infrastructure, and create new jobs. Before eliminating these tax-exempt financings, I urge you to weigh carefully how little the country might gain and how much there is to lose.

Thank you.

The CHAIRMAN. Thank you.

Dr. Galper.

[Mr. Hughes' written testimony follows:]

STATEMENT OF JAMES J. HUGHES, JR., EXECUTIVE DIRECTOR, NEW JERSEY ECONOMIC DEVELOPMENT AUTHORITY, ON BEHALF OF THE COUNCIL OF INDUSTRIAL DEVELOPMENT BOND ISSUES

Mr. Chairman and Members of the Committee. Thank you for this opportunity to comment on the President's Tax Plan, with particular emphasis on tax-exempt financing. I am James J. Hughes, Jr., President of the Council of Industrial Development Bond Issuers (CIDBI), a national organization of more than 100 state and local government issuers dedicated to the responsible use of Industrial Development Bonds (IDBs) for economic development and growth. I am also Executive Director of the New Jersey Economic Development Authority.

If adopted in its present form, the proposed legislation has consequences which would be enormous and frightening, with approximately 2/3 of all projects now eligible to be financed with tax-exempt bonds losing that well established and well earned right. Thus, you're constituents face the major risk of losing outright, or postponing, long-term investments to upgrade their respective quality of life. At best, these financing would become much more expensive for the voters back home; at worst, they would become economically impossible. These investments are at risk because certain ideologues have disparaged financing partnerships between the public and private sector for pollution control, student loans, hospitals, housing and job creation as being "non-governmental."

But I ask you what is non-governmental about investing in tomorrow's brainpower through student loans promoting educational quality and opportunity for growth of our human resources?

What is non-governmental about stimulating investments in affordable housing for people of low and moderate incomes? That has been a fundamental priority of national policy for decades, so why should resources to accomplish it be suddenly withdrawn and further denied to the states?

What is non-governmental about investing in environmental clean-ups? Our urban regions are desperate for solutions to the hazards of chemical waste, for example, so much so that the Committee voted last month to expand the authorized uses of tax-exempt bonds to address this public imperative. Yet now we have a proposal which dismisses this challenge of environmental quality as a non-public purpose.

Finally, what is non-governmental about stimulating investments in economic growth that create new jobs and greater productivity in this country, rather than overseas? Now that Congress has placed volume controls and other restrictions on small issue Industrial Development Bonds (IDBs), this financing incentive is being targeted increasingly towards smaller businesses for expansion proposals not otherwise possible.

The substantial cost savings inherent in tax-free financing is what the President's tax plan would take away. It can amount to between 2 and 5 points of interest rate reduction annually, and if anyone here has bought a home lately, you can appreciate what a difference that would make in your monthly mortgage payments. It usually makes the difference in "go" and "no go", between "jobs and no jobs;" it makes available otherwise unaffordable housing, otherwise unobtainable, higher education, better health care, and an improved environment. For these reasons, the proposal to tax "non-governmental" bonds - used to finance activities explicitly recognized by past federal policies as legitimate and desirable public objectives - demands careful scrutiny.

Removing the tax exemption thus represents a major cost shift from the federal government to states and localities, regardless of whether the project financing entails renovating a non-profit hospital or installing scrubbers to combat acid rain. Most of these long-term investments must go forward sooner or later, and your constituents will be forced to pick up the higher price tag. Based on my experience in New Jersey and studies in this area, that tab could be substantial. The denial of tax-exemption will translate into higher taxes or user fees combined with some shrinkage of services at the state and local level.

Let's examine how the Administration justifies this tax shift. They assert that "non-governmental" borrowing erodes the federal tax base and "forces increases in the tax rates on non-exempt income". This latter claim cannot be demonstrated, particularly because at no time during the past 10 years covered by the Treasury's analysis have tax rates gone up. Instead, rates have been lowered dramatically on the individual side.

As for federal revenue loss, Treasury calculations are erroneous because they deny the existence of tax re-flows from the extra economic activity that occurs (i.e. additionality), and because they presume that all IDB investors would alternatively invest their money in a taxable instrument.

Let's look specifically at re-flows in the area I know best -- that of small issue IDBs for business expansions under $10 million. At the New Jersey Economic Development Authority, we conducted a study, based on fiscal year 1981 data, that indicated, on a national basis, IDB-financed projects generated in excess of $3 billion in total tax receipts for the federal government. Additionally, the study indicated that nearly $2 billion was added to state and local government receipts. These findings certainly question the purported revenue losses that some attribute to this program. Since citing statistics from only one state is inadequate, we have commissioned, through the Council of IDB Issuers, a national evaluation of tax reflows and this "additionality" resulting from IDB usage. In August, we intend to provide you information, based on empirical data from IDB users nation-wide, showing whether the responsible use of small-issue IDBs adds to the federal deficit, or helps you reduce it.

I would ask the Committee to allow us to make CIDBI's results part of this record when the study is released in August. The Public Securities Association, I should add, will soon release its own study on all categories of "non-governmental" bonds assessing the costs to the Treasury of these financings.

On the issue of "non-governmental" bonds pushing up the interest rates of traditional obligations of state and local governments, I would merely ask for the evidence. Virtually all studies minimize this causal effect. Under the small issue IDB program, for example, our membership survey shows that more than 80% of these financings are privately placed. Consequently, any effects on the public credit markets are almost negligible. There are differing markets and we must recognize this fact. Again, I urge the Committee to carefully review the record in this area.

Next the Treasury asserts that IDBs are anti-competitive and distort the marketplace, which applies a test to this program not applied in virtually any other governmental area. By definition, any government program or regulation represents an interference in the free market. To carry this argument to its extreme would require us to abandon environmental regulation, farm price supports, and so on.

Finally, not once in the discussion does the Administration even acknowledge the work of so many of you on this Committee and others to reach agreement in 1984 on significant changes and reforms in the tax-exempt bond area. Congress approved a significant state-by-state limitation on bond volume that covers several categories of non-governmental bonds, yet the Administration's analysis of current law does not even mention the volume cap and their chart of bond volume issuance ends in 1983, the last year before the cap took effect. I would add that for those activities now under the cap, bond volume will be reduced by 33% from $150 per capita to $100 per capita on January 1, 1987. So let's debate the issue considering circumstances that apply to 1985, not the record applicable to 1981.

And in 1985, the competitive situation that should worry all of us is an annual trade deficit over $100 billion. With American business struggling to compete, we should be frightened by any proposal that raises the cost of capital for domestic investment. As a former Chairman of the Council of Economic Advisors recently wrote in the Wall Street Journal, "with the budget deficit absorbing more than half of the net savings generated in the economy, we need to strengthen the incentive to invest in plant and equipment rather than to dissipate the available savings on other uses." But the President's proposal on tax-exempt bonds would have the opposite effect.

Moreover, there is a much more serious distortion caused by the President's tax-exempt bond proposal, one that contradicts the central thrust of the Reagan Revolution - reducing the role of government by privatizing services. Instead, the high financing costs associated with the taxable bond alternative will encourage governments to increase their ownership and operation of many facilities that could be more efficiently run by private companies, in order to take advantage of the tax-exempt status of governmental bonds. Hence, privatization and public/private partnerships will become more difficult, as local governments chase the objective that they can deliver a technologically complex service like resource recovery more cheaply than could a private engineering company. One can conceive scenarios in which your constituents would become double losers - poorer services, yet more costly debt repayments because of higher construction costs, albeit financed with public purpose tax-exempt debt. And given this incentive to convert current "non-governmental" bonds to be eligible governmental financings, the volume of tax-exempt borrowing won't decrease nearly as much as the Treasury predicts.

In conclusion, I urge this panel to consider whether the federal government should deprive state and local governments of the ability to allocate investment incentives to achieve important public benefits. Last week the Joint Economic Committee released its annual national survey of the fiscal health of the nation's cities. IDBs represented the single, most important program in their local efforts to promote economic development. Clearly, these same communities should be every bit as concerned as the Treasury Department about the effect of "non-governmental" bonds on their borrowing costs for general obligation debt. Yet they have concluded that they are willing to accept some minimal increase in borrowing costs associated with "non-governmental" bonds in exchange for increased tax receipts, services and facilities to meet important community needs. A public declaration this week by eleven public interest groups (representing Governors, Mayors, State Legislatures, et al), unanimously opposing the tax-exempt bond provisions of the President's proposal, also shows that the Treasury's "we know what's best for you" attitude is not well-received.

The fundamental issue therefore becomes how rigid a straight-jacket can the federal government impose upon the states? After five years of transferring every possible responsibility to states and localities, is it fair to rob them of the resources and tools to pay for the long-term investments so critically needed across the country? For a small tax expenditure, you can stimulate billions of dollars in investments in facilities that will directly benefit your constituents.

And if Congress does strip this financing power away, I'll wager that whenever interest rates and unemployment resume their upward march towards some inevitable recession, public clamor will demand affordable capital to build housing, repair infrastructure and create new jobs. Before eliminating these tax-exempt financings, I urge you to weigh carefully how little the country would gain when there is so much to lose.

STATEMENT BY DR. HARVEY GALPER, SENIOR FELLOW, THE BROOKINGS INSTITUTION, WASHINGTON, DC

Dr. GALPER. Thank you, Mr. Chairman and members of this committee. I am pleased to be here to have the opportunity to testify today on the use of tax-exempt borrowing for nongovernmental purposes.

I strongly believe that the privilege of issuing tax-exempt bonds should be limited to strictly governmental entities and for strictly governmental purposes, difficult as that determination may be. I take it that it is not the position of Mr. Hughes that since providing a health economy is in the national interest, all financing should be tax exempt.

Now, the reasons why I oppose the use of tax-exempt financing for nongovernmental purposes are the following:

Tax exemption, first, is merely another form of Federal subsidy paid for by Federal taxpayers and should be evaluated as such. We must not be misled by artificial distinctions between tax subsidies and direct outlays.

Furthermore, the growth in nongovernmental tax-exempt bonds has been extraordinary in recent years. The Treasury has just made available figures for 1984, which are on the back of my testimony, the very last page. The growth was over 25 percent in 1984 alone; and the use of tax-exempt financing for private purposes has increased 2.5 times since 1981.

Second, the effect of the subsidy of tax exemption is to encourage undesirable interstate competition, as each State feels forced to offer tax-exempt financing to private borrowers in response to the offerings of other States. The results of this interstate competition is not to create new jobs in any aggregate sense, but rather to reshuffle existing jobs among States depending on the success of each State in attracting facilities from neighboring jurisdictions.

Third, the subsidy provided by tax exemption is a particularly inefficient one in that the benefits to the ultimate borrower are much less than the costs to the Federal Treasury. Treasury revenue estimating procedures have been critized in this regard as yielding static estimates. And I might say in this regard that whenever revenue estimates are attacked you can be sure that this is the last refuge of people unwilling to look at the fundamentals of the program. These estimates are done jointly with congressional staff, jointly with the Joint Tax Committee. It is a very difficult area to do revenue estimates on—I know; I have done them myself—but if you use more refined techniques the results will show, if anything, that Treasury estimates understate the revenue cost to the Federal Government rather than overstate them. And I hope you have a chance to debate that issue.

Fourth, tax-exempt financing for nongovernmental purposes increases the interest rates that must be paid by States, localities, and school districts. The extent of the increase is subject to some dispute; but there is no question that higher interest rates must prevail if there are indeed additional volumes of tax-exempt financing pushed onto the market.

In fact, if we are concerned about infrastructure, if we are concerned about financing the basic facilities of State and local government, then we should be very concerned about not competing in State and local markets with essentially private-purpose bonds.

Fifth, tax exemption gives preferred borrowers a competitive advantage over other borrowers within a state who are not able to take advantage of below-market tax-exempt rates.

In this connection, I should note that to the extent that the pressures for tax-exempt financing arise from the still high real interest rates prevailing in the economy today, the appropriate response is to bring down those interest rates for all borrowers. This requires that the Federal deficit be attacked directly by both expenditure cuts and revenue increases. We can ill afford to lose further revenues to an inefficient subsidy program; rather, we must both reform our tax system and reduce the Federal deficit so that moderate costs of financing are available to all homeowners and all businesses.

Thank you.

The CHAIRMAN. Thank you very much.

Dr. Hufbauer.

[Dr. Galper's written testimony follows:]

STATEMENT OF HARVEY GALPER*

BEFORE THE COMMITTEE ON FINANCE

UNITED STATES SENATE

JUNE 25, 1985

Mr. Chairman and members of this committee:

I am pleased to have the opportunity to testify today on the subject of the use of tax-exempt borrowing for non-governmental purposes. I strongly believe that the privilege of issuing tax-exempt bonds should be limited to strictly governmental entities and for governmental purposes. All non-governmental uses should be eliminated as quickly as possible.

The reasons for this position are as follows:

1. Tax exemption is merely another form of federal subsidy. The costs of this subsidy are large and have grown substantially in recent years. At a time when governmental programs are being cut back across-the-board there is no justification for maintaining this subsidy.
2. The effect of the subsidy of tax exemption is to encourage undesirable inter-state competition, as each state feels forced to offer tax-exempt financing to private borrowers in response to the

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*Harvey Galper is a Senior Fellow in the Economic Studies Program at the Brookings Institution.

offerings of other states. The results of this interstate competition is not to create new jobs in any aggregate sense, but rather to reshuffle existing jobs among states depending on the success of each state in attracting facilities from neighboring jurisdictions.

3. The subsidy provided by tax exemption is a particularly inefficient subsidy in that the benefits to the ultimate borrower are much less than the costs to the federal Treasury. Treasury revenue estimating procedures have been criticized in this regard as yielding static estimates. The use of more sophisticated models, however, indicate that, if anything, Treasury's estimates understate the revenue costs to the federal government.
4. Tax-exempt financing for non-governmental purposes increases the interest rates that must be paid by states, localities, and school districts.
5. Tax exemption gives preferred borrowers a competitive advantage over other borrowers within a state who are not able to take advantage of below-market, tax-exempt interest rates. By far the best way to provide a healthy climate for investment is by reducing the federal deficit, thereby lowering interest rates for all businesses rather than for selected businesses able to use tax-exempt financing.

I will now elaborate briefly on each of these points in turn.

Tax Exemption is a Subsidy.

As a prerequisite to understanding appropriate public policy in this area, we must not be misled by artificial distinctions between tax subsidies and direct outlays. Tax exemption for particular categories of borrowing is as much of a subsidy as a direct payment to borrowers. Accordingly, tax subsidies should be evaluated by the same tests that we would apply in determining whether direct outlays--farm subsidies, preferred financing for exports, or transportation subsidies--are in the national interest.

Furthermore, as the data compiled by the Treasury Department in Table 1 indicates, the growth in non-governmental tax-exempt bonds has been extraordinary in recent years. The growth was over 25 percent in 1984 alone, and has increased almost two and one-half fold since 1981. In fact, Figure 1 shows that tax-exempt financing for small issue industrial development bonds (less than $10 million each of face value), mortgage subsidy bonds, and bonds for private hospitals exceeded total tax-exempt financing for all state, local, and school-district issues in 1984. With 63 percent of the total volume of long-term tax-exempt bonds now being issued for non-governmental purposes, it is clear that the original purpose of tax-exempt financing--as a means of achieving comity in the federal system--is a decidedly minority purpose. Far from a privilege accorded to sovereign states, tax-exempt financing is now an instrument for reducing the costs of borrowing to a wide range of potential claimants from single-family home-owners to private hospitals to major corporations.

Consistent with the growth of tax-exempt financing for non-governmental purposes, the cost to the Treasury of this financing has also grown. In the current fiscal year, the Treasury has incurred a revenue loss of almost $10 million from non-governmental bonds and by 1990 this number can be expected to double. From just small issue IDBs issued in 1983, the Treasury estimates the revenue loss will total $8 billion over the period the bonds are outstanding. For this reason, the revenue gain estimated in the President's proposal for 1986--only $0.3 billion--is the merest beginning of the revenues that can be raised from eliminating tax exemption for non-governmental bonds. By 1990 over $4.5 billion will be raised and the numbers continue to grow on into the future. It is precisely because the stock of outstanding tax-exempt debt for private purposes can grow so rapidly--it is now estimated to represent over 45 percent of all tax-exempt bonds outstanding--that it is necessary to move as quickly as possible to confine tax-exempt financing to genuine governmental purposes. Once bonds have been issued on a tax-exempt basis, it is too late to remove the subsidy.

Tax Exemption Encourages Undesirable Interstate Competition

A major reason for the growth in non-governmental tax-exempt borrowing has been noted by both the Treasury and the Advisory Commission on Intergovernmental Relations (ACIR). This reason is that in a federal system each state is forced to respond to the programs offered by other states, particularly if they impose little or no costs on state taxpayers. Thus, as the ACIR notes, "Small issue industrial development bonds have been used as a tool in interstate and interjurisdictional competition for jobs and industry."[1] It is clear in this context that each state is perfectly happy to offer potential businesses below-market financing that costs the taxpayers of the state next to nothing since the costs are borne by all taxpayers throughout the country. While each individual state's developmental authorities find that the offer of tax-exempt financing may be a useful part of a total industrial developmental program, the proper perspective from the point of view of federal policymakers is whether federal taxpayers are getting their money's worth. The fact that one state or another may be able to entice industry at the expense of neighboring states does little to promote the national interest. Nor is it clear why the federal government should encourage states to compete with each other in a way that only reduces federal revenues that must be made up by increasing taxes elsewhere.

The ACIR report also quotes a study for the state of Michigan in which both the state and national perspectives are made quite clear. The Michigan report stated that "From a state policy perspective, [industrial development bond] programs in Michigan probably yield net positive benefits to state taxpayers on a collective basis...An assessment of [such] programs at the national level is quite different...It may be in the interest of all taxpayers to hold back on further...issues. The paradox is that all may lose or all pursue their self-interest, yet each state has no assurances that its restraint will be matched by the restraint of other states."[2] This same Michigan study also questioned the aggregate job-creating aspects of industrial development bond financing. This study states "Whether viewed from either the national or state level, the broad subsidization of capital is inefficient in encouraging new employment and ineffectual in promoting economic stability. As the system now exists, use of the program has grown dramatically, but the firms that are likely to be attracted to it do not necessarily create permanent, steady, employment opportunities."[3]

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[1] Advisory Commission on Intergovernmental Relations, Strengthening the Federal Revenue System: Implications for State and Local Taxing and Borrowing, October 1984, p. 120.

The Subsidy Provides by Tax Exemption is Particularly Inefficient One

The inefficiency of tax exemption has several dimensions, but the combined effect is that the savings to ultimate beneficiaries are far less than the revenue loss to the federal government. According to the Treasury Department, studies show that at least one-third of the benefit of tax-exempt financing may go to financial intermediaries and

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2. ACIR, pp. 121-122.

3. ACIR, p. 122.

high-bracket investors rather than to the ultimate borrowers. The Congressional Budget Office has estimated that even less--in some cases, only one-fourth--of the federal revenue loss subsidizes intended beneficiaries.

A major reason for the inefficiency is that high-bracket taxpayers can receive a windfall from holding tax-exempt bonds. Additional reasons are the fees to underwriters, promoters, and even amounts retained by the issuing state or local intermediaries. Other reasons why the subsidies are inefficient vary with the particular purpose of the loan. In the case of multi-family housing, for example, only 20 percent or more of the units in a project financed by IDBs has to be occupied by individuals of low or moderate income. Thus the subsidy is not highly targeted to the intended recipient population. Furthermore, if in less-than-perfect rental markets, only a small fraction of the subsidy is reflected in lower rents, another source of slippage exists in achieving the intended purpose.

In the case of pollution-control bonds, the tax-exempt financing is available to businesses that invest in pollution-control devices in order to comply with federal regulations. Thus, the use of tax exemption does nothing to encourage investment that would not otherwise occur and only serves the purpose of preventing the full costs of pollution control from being reflected in market prices paid by consumers, another source of inefficiency. Tax-exempt financing for student loans, a program that is being phased out, still suffers from a high degree of inefficiency in that the tax-exempt financing does nothing to reduce the interest rates faced by ultimate borrowers.

In general, as the ACIR notes, "Tax-exempt bonds may encourage projects which serve little or no public purposes; small issue IDBs encourage small projects at the expense of larger ones, regardless of economic efficiency; tax-exempt financing favors businesses or persons eligible to receive it, at the expense of ineligible businesses or persons."[4]

By far, however, the greatest amount of controversey surrounds the calculation of the revenue costs to the federal Treasury and the inherent inefficiency of tax exemption as a subsidy. The argument has been made that the revenue-estimating procedures used by Treasury overstate the revenue loss and therefore the inefficiency of tax-exempt financing. The reasons behind this criticism, however, must be clearly identified. To the extent that additional revenues are thought to be generated from the job-creating effects of IDB financing, there is very little truth to these allegations. As already indicated, the best that IDBs can do is to move jobs from one location to another with little net aggregate effect. Furthermore, to the extent that taxes must be increased on all other taxpayers to offset the revenue loss from tax-exempt financing, other economic activity will be suppressed to about the same degree as IDB-financed activity is encouraged. With a given revenue target, one can not look at IDB-financing as stimulating the economy through the effects of a general tax cut. In fact, even if a tax cut is desired, hardly the need in today's economic environment, there are much more effective ways of providing one than through selected tax benefits to particular categories of borrowers.

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[4] ACIR, p. 129.

Another criticism of Treasury estimating procedures involves the determination of the marginal tax rate to be applied in calculating the revenue loss from additional amounts of tax-exempt financing. Under traditional models, the marginal tax rate was related to the spread between tax-exempt and taxable yields, on the order of 25 percent. The criticism has been made that this marginal tax rate is too high because individuals do not directly move out of tax-exempt bonds into taxable bonds when fewer tax exempts are available, but instead they move into other tax shelters, and this generates smaller amounts of revenue on the margin.

Although in a general sense this criticism has some validity, the final result of following this logic through to the end may surprise the critics. It is true that the final consequences of increasing tax-exempt financing and reducing taxable financing can not be determined merely by assuming that some taxpayers decide to hold more of the former and less of the latter. A whole series of adjustments are likely to occur in response to this change and associated changes in relative rates of return, all of which will affect Treasury revenues. Recently, portfolio choice models have become available which can analyze the full range of portfolio adjustments to changes in the volume of tax-exempt financing undertaken.[5] These models indicate that, if anything, the traditional approach to estimating the revenue lose from tax-exempt financing understates the true loss. This occurs because substitution between tax-exempt and taxable financing occurs not just for taxpayers whose marginal tax rates are close to the yield spread between tax-exempt and taxable bonds--about 25 percent. Rather taxpayers in higher brackets as well will move out of taxable securities and into tax exempts as more of the latter become available. This is true even though such high-bracket taxpayers may be holding corporate equities or partnership shares in unincorporated businesses at the same time. When all portfolio adjustments are taken into account the net effect will be that a greater revenue loss will occur than will be determined by applying a 25-percent marginal tax rate. The revenue estimates from these dynamic response models show that the standard estimates may have to be increased by 20 percent to capture the full portfolio adjustment effects.

There is a partial offset, however. The increase in tax-exempt financing and the reduction in taxable financing serves to increase tax-exempt interest rates somewhat but also to reduce taxable rates.

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[5] See, for example, Eric Toder and Thomas S. Neubig, "Revenue Cost Estimates of Tax Expenditures: The Case of Tax-Exempt Bonds," presented at the spring symposium of the National Tax Association-Tax Institute of America, May 20-21, 985.

The reduction in taxable rates represents a net lower cost to the U.S. Treasury in financing its own debt. Even taking this into account, however, the total budgetary effect of tax-exempt financing is higher than that estimated under the traditional approach.

Tax-Exempt Financing Increases Interest Rates for Governmental Borrowers

As noted above, increased usage of tax-exempt financing will raise the borrowing costs for traditional governmental purposes. The extent of such cost increases is subject to question, and empirical estimates have provided a wide range of possible effects. It may well be that the absorptive capacity of the market for tax-exempt bonds varies substantially over time and that precise determinations of the increased costs to state and local borrowers is difficult to quantify.

The sign of the effect is unarguably positive, however. Furthermore, the effect is one that has been identified by state and local officials as troublesome. The Advisory Commission on Intergovernmental Relations, in this regard, quoted a letter to members of the New York Congressional delegation from New York State Comptroller Edward V. Regan. Based on private-purpose, tax-exempt debt issued in 1982, and using an estimate that each $1 billion of additional tax-exempt debt drives up all tax-exempt interest rates by three basis points (a basis point is equal to 1 one-hundredth of one percent), the Comptroller estimated that a recent New York State bond issue of $1.25 billion will carry higher interest costs amounting to almost $10 million each year for 25 years as a result of non-governmental borrowing in 1982. Also, New York State's general obligation bond sale in February 1984 will cost New York State taxpayers an additional $19 million over the term of the bonds.[6]

This is clearly an area where the federal government must exercise authority. Despite the additional costs imposed on all state and local borrowers, no single borrower will have any incentive to limit its own use of tax-exempt financing for non-governmental purposes, if some benefit to the individual state is believed to be obtained from that financing. Again, the effect of interstate competition makes it virtually impossible for these governments to refrain from bidding up their own interest costs.

Tax Exemption Subsidizes Selected Borrowers

Finally, there is no reason why a national subsidy should be provided to selected borrowers, not chosen as part of any national program. The preferred borrowers are in direct competition with other businesses that are not able to obtain below-market interest rates. Thus, the program sets up a system of unfair competition within the business community and may very well lead to the result that inefficient operations that qualify for tax-exempt financing crowd out other more efficient operations that must pay full market rates.

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[6] ACIR, pp. 127-128.

This leads me to one final observation. To the extent that the pressures for tax-exempt financing arise from the still high real interest rates prevailing in the economy today, the appropriate response is to bring down those interest rates for all borrowers. This requires that the federal deficit be attacked directly by both expenditure cuts and revenue increases. We can ill afford to lose further revenues to an inefficient subsidy program. Rather, we must both reform our tax system and reduce the federal deficit so that moderate costs of financing are available to all homeowners and businesses

FIGURE 1

Volume of Long-Term Tax-Exempt Bonds Issued In 1984

(Amounts in $Billions)

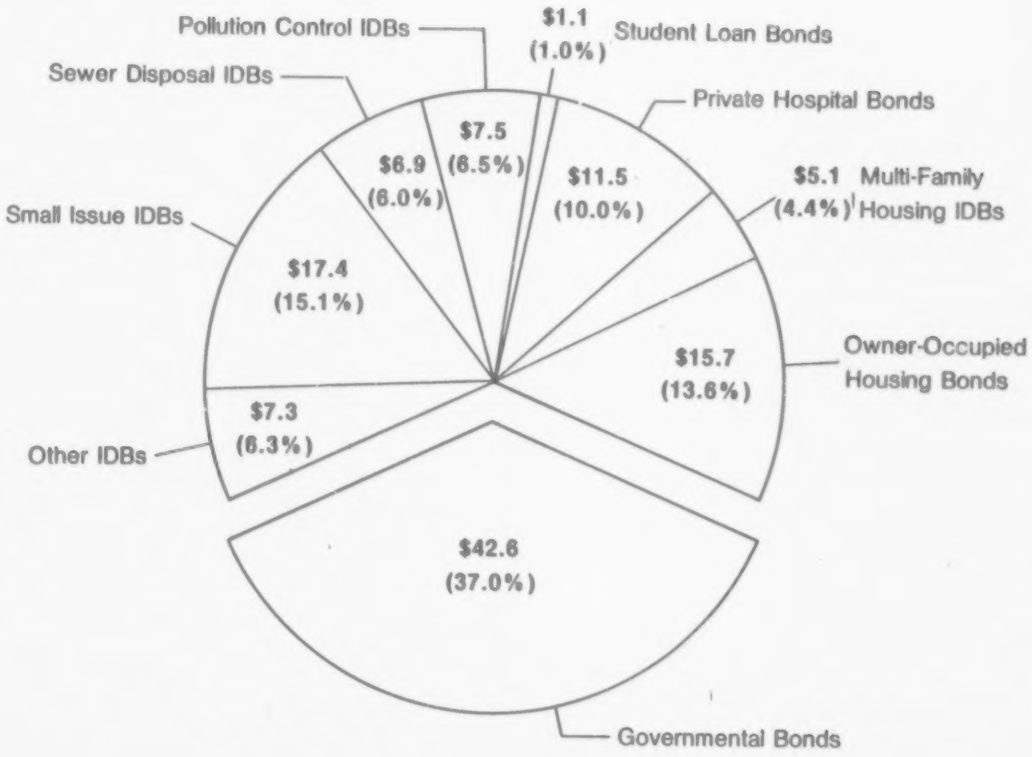

Table 1

Volume of Long-Term Tax-Exempt Bonds by Type of Activity, 1975-1984

(In billions of dollars)

	Calendar Years									
	1975	1976	1977	1978	1979	1980	1981	1982	1983	1984
Total issues, long-term tax exempt bonds 1/	30.5	35.0	46.9	49.1	48.4	54.4	55.1	84.9	93.3	115.1
Nongovernmental tax exempt bonds	8.9	11.4	17.4	19.7	28.1	32.5	30.9	49.6	57.1	72.5
Housing bonds	1.4	2.7	4.4	6.9	12.1	14.0	4.8	14.6	17.0	20.8
Single family mortgage subsidy bonds	*	0.7	1.0	3.4	7.8	10.5	2.8	9.0	11.0	13.5
Multi-family rental housing IDBs	0.9	1.4	2.9	2.5	2.7	2.2	1.1	5.1	5.3	5.1
Veterans' general obligation bonds	0.6	0.6	0.6	1.2	1.6	1.3	0.9	0.5	0.7	2.2
Private exempt entity bonds 2/	1.8	2.5	4.3	2.9	3.2	3.3	4.7	8.5	11.7	11.6
Student loan bonds	*	0.1	0.1	0.3	0.6	0.5	1.1	1.8	3.3	11.1
Pollution control IDBs	2.1	2.1	3.0	2.8	2.5	2.5	4.3	5.9	4.5	7.5
Small issue IDBs	1.3	1.5	2.4	3.6	7.5	9.7	13.3	14.7	14.6	17.4
Other IDBs 3/	2.3	2.5	3.2	3.2	2.2	2.5	2.7	4.1	6.0	14.0
Other tax-exempt bonds 4/	21.6	23.6	29.5	29.3	20.3	22.0	24.2	35.3	36.2	42.6

Office of the Secretary of the Treasury
Office of Tax Analysis

June 21, 1985

Note: Totals may not add due to rounding.

* $50 million or less.

1/ Total reported volume from Bond Buyer Municipal State Book (1985) adjusted for privately placed small issue IDBs.

2/ Private-exempt entity bonds are obligations of Internal Revenue Code Section 501(c)(3) organizations such as private nonprofit hospitals and educational facilities.

3/ Other IDBs include obligations for private businesses that qualify for tax-exempt activities, such as sewage disposal, airports, and docks.

4/ Some of these may be nongovernmental bonds.

STATEMENT OF DR. GARY C. HUFBAUER, COUNSEL, ROSE, SCHMIDT, CHAPMAN, DUFF & HASLEY, WASHINGTON, DC

Dr. HUFBAUER. Thank you, Mr. Chairman.

The proposal to eliminate tax exemption represents the second part of a fiscal double-whammy proposed by the Federal Government for State and local governments. This proposed double-whammy comes at a time when Federal policies have driven real interest rates to record sky high levels.

I think we all understand that eliminating the deduction for State and local taxes is one of the two or three major revenue-building blocks for tax reform; but the same cannot be said of the proposal to eliminate tax exemption for so-called nongovernmental State and local debt.

The Treasury and the CBO have vastly overstated the revenue costs to the Federal Government of tax-exempt debt; consequently, they have greatly exaggerated the prospective revenue yield from eliminating tax exemption.

The Treasury/CBO revenue-estimation methods contain three important errors. These are spelled out in detail in my written statement, and let me just summarize them here.

First, the Treasury/CBO method uses a marginal tax rate that is no longer appropriate.

Second, the Treasury/CBO method ignores or trivializes feedback effects. One need not be a raving supply-side fanatic to believe that tax-exempt finance can make an important contribution to investment in human and physical capital, and thereby add to the Nation's productive capacity and ability to save. It is on that point that I find the greatest disagreement with Dr. Minarik and Dr. Galper.

Third, the Treasury/CBO method understates the impact of smaller interest deductions taken by users of tax-exempt finance on the overall revenue cost of the tax-exemption feature.

All in all, a judicious reestimation will reveal that tax exemption entails far lower revenue costs than the Treasury/CBO figures would indicate. I understand that the Public Securities Association will soon publish numbers on the revenue question.

Apart from the revenue mirage, the Treasury seems to have three backup arguments for proposing the end of tax exemption.

First, the Treasury argues that nongovernmental tax exempts will spoil the market for governmental tax exempts. This argument has a kernel of truth, but it is quite exaggerated by the Treasury. Recent estimates indicate that the impact on the yield spread resulting from an extra $1 billion of nongovernmental debt is only about two basis points. That is about one-sixth of the early estimates of the impact.

Next, the Treasury argues that tax exemption creates a wedge of waste—namely that the interest savings benefit to the borrower is less than the tax saving to the fat-cat high-bracket bond holder. There are two problems with this argument. First, it would ring more true if the Treasury promised an interest rate subsidy—for example, through an interest rate credit—to make up for the benefits of tax exemption, so the same goals could be achieved without this wedge of waste going to the fat-cat investors. But the Treasury, of course, has made no such proposal.

Second, the wedge of waste probably amounts to no more than 1 percent of the capital funds raised in the debt markets and devoted to State-approved projects. It would be really quite difficult to run an explicit subsidy program with an administration cost of only 1 percent.

Finally, the Treasury argues that tax-exempt bonds are anticompetitive and distort the market. Even if the President's tax plan is implemented tomorrow, the Federal tax system will contain numerous distortions, or incentives, depending on how you look at them. The real issue is not the continued existence of incentives; the real issue is whether States and localities will be allowed to use tax-exempt finance in carrying out public purposes.

Clearly there must be limits on the imagination of bond counsel, but I think that TEFRA did a good job of enumerating those limits.

Thank you very much.

[Mr. Hufbauer's written testimony follows:]

STATEMENT OF GARY CLYDE HUFBAUER, ROSE, SCHMIDT, CHAPMAN, DUFF & HASLEY

1. Mr. Chairman, I welcome this opportunity to testify on tax-exempt financing. I am appearing on behalf of Rose, Schmidt, Chapman, Duff and Hasley, a Washington law firm representing small business firms and other clients interested in tax-exempt financing. My prior experience includes seven years with the U.S. Treasury Department and assorted professorial positions in economics. Currently I am a Senior Fellow with the Institute for International Economics in Washington.

2. The President's tax reform plan contains a grand slam fiscal assault on state and local governments. First, there is the denial of the deduction for state and local taxes. This action would raise $149 billion in additional federal tax collections over the five years 1986-90. Next there is denial of tax-exempt status for "nongovernmental" state and local bonds. This action would supposedly raise $16 billion over fiscal years 1986-90 (for reasons outlined below, this estimate is badly flawed). Together, these actions account for nearly 50 percent of the individual income tax increases--totaling some $354 billion over the years 1986-90--contained in the President's plan.[1] These proposals come at a time when the federal government is calling on state and local governments to shoulder a larger share of public responsibilities.

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[1] These increases are, of course, offset by individual rate reductions, which will cost the Treasury some $486 billion over the next five years. The figures cited here are taken from Deloitte, Haskins and Sells, The President's Tax Reform Plan, 1985, p. 5.

3. The federal government decisively affects the level of interest rates through monetary policy, fiscal policy and tax policy. In recent years, these federal policies have pushed nominal and real interest rates to astronomical levels. State and local governments have practically no voice in determining interest rates. Unlike the federal government, state and local governments are prevented by their own constitutions and the credit markets from issuing unlimited amounts of debt.

4. In other words, the federal government has created an environment of record high interest rates, but the federal government can largely escape the consequences of that environment by issuing more Treasury debt. It seems churlish and overbearing of the federal government to preclude state and local governments from seeking their own small measure of relief through tax-exempt finance.

5. The Treasury argues that "nongovernmental" tax-exempt financing spoils the market for "governmental" tax-exempt financing.[2] More of one raises interest rates on the other. Everyone agrees there is some effect. The question is how

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[2] Terminology is important because words are sometimes labels, and labels convey unspoken arguments. The prejudicial label "nongovernmental" underpins the Treasury's divide-and-conquer strategy of distinguishing "governmental" tax-exempt finance from "nongovernmental" tax-exempt finance. However, nearly all "nongovernmental" tax-exempts are issued to further goals that, at one time or another, the federal government itself regarded as proper objects of public policy.

much. Early enthusiastic estimates placed the impact as high as 13 basis points of additional spread per $1 billion increase in "nongovernmental" tax-exempt finance.[3] More recent estimates place the impact as low as at 0.6 basis points.[4] The most plausible study places the impact at 2 basis points per $1 billion.[5]

6. In 1983, the amount of new "nongovernmental" tax-exempt debt issued was $57 billion, while "governmental" tax-exempt debt was $36 billion. A 2 basis points per $1 billion coefficient suggests that states and localities may have paid about $400 million extra interest on their "governmental" tax-exempt debt. I suspect that states and localities, if polled, would regard this as a bargain. I doubt that they want the Treasury to do them the favor of eliminating tax-exempt "nongovernmental" debt so they can save 114 basis points on "governmental" debt.[6]

7. Turning to revenue estimates, the Treasury/CBO method of

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[3] Harvey Galper and George Peterson, "Tax Exempt Financing of Private Industry's Pollution Control Equipment", Public Policy, Winter 1975, pp. 81-103.

[4] Roger Kormendi and Thomas Nagle, "The Interest Rate and Tax Revenue Effects of Mortgage Revenue Bonds," in Herbert Kaufman, editor, Efficiency in the Municipal Bond Market: The Use of Tax-Exempt Financing for Private Purposes, JAI Press, Greenwich Connecticut, 1981, pp. 117-148.

[5] DRI, An Analysis of Tax Exempt Polution Control Financing, June 1983, Appendix A.

[6] The figure of 114 basis points is calculated as $57 billion times 2 basis points per $1 billion.

estimating the federal revenue loss from "nongovernmental" tax-exempt financing is badly flawed. According to the CBO, the revenue loss under current law from all outstanding "nongovernmental" tax-exempt bonds will be $14.6 billion in fiscal 1986.[7] Basically, the Treasury/CBO rule-of-thumb method assumes that each $1 billion of new tax-exempt debt costs the U.S. Treasury about $30 million annually in lost revenue. This approach assumes that the average investor in tax-exempt securities pays a marginal tax rate of about 30 percent, and that this investor would otherwise buy taxable securities with a yield of about 10 percent. Hence:

Revenue loss per $1 billion of new tax-exempt debt =
(30 percent) x (10 percent) x $1 billion = $30 million

In practice, year-to-year adjustments and certain small corrections are made in the $30 million per $1 billion coefficient. However, the Treasury/CBO method overlooks or minimizes some very important offsets.

8. In the first place, the assumed 30 percent marginal tax rate is derived from the historical relationship between tax-exempt yields and taxable yields--over a long period of time, the tax-exempt yields have been about 70 percent of taxable yields.

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[7] CBO, Reducing the Deficit: Spending and Revenue Options, February 1985. This figure implies an outstanding stock of "nongovernmental" tax-exempt bonds of about $483 billion.

The Treasury/CBO method reasons that investors equate the yield received on tax-exempts with what they might have earned, after federal tax, from an investment in taxable bonds. Hence, a 30 percent marginal tax rate is assumed.

9. However, during the years 1981 to 1984, tax-exempt yields have moved up from 70 percent to about 80 percent of taxable yields.[8] This may well reflect the tax rate reductions in 1981.[9] In any event, following the Treasury/CBO method, the appropriate coefficient of revenue loss for newly issued "nongovernmental" tax-exempts should now be about $20 million per $1 billion, rather than $30 million per $1 billion.[10]

10. In the second place, the Treasury/CBO method either ignores "feedback" effects or estimates them using a model designed to give a trivial result. One need not be a raving supply-sider to imagine that "nongovernmental" tax-exempt

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[8] Economic Report of the President, February 1985, p. 310.

[9] Contrary to assertions by the Treasury, the change in yield relationships between tax-exempt and taxable bonds is not necessarily caused by the larger volume of "nongovernmental" tax-exempt bonds. Chart 1, taken from a Kidder Peabody study, shows that the ratio between tax-exempt and taxable interest rates often exceeded 80 percent in the late 1960s and early 1970s, a period when the volume of "nongovernmental" tax-exempts was small relative to "governmental" tax-exempts.

[10] This point was virtually acknowledged by CBO under questioning by Congressman Downey in 1983. See U.S. Congress, House of Representatives, Committee on Ways and Means, Hearings on Trends in Municipal Financing and the Use of Tax-Exempt Bonds to Finance Private Activities, Serial 98-30, June 15-16, 1983, pp. 61-64.

financing can make significant additions to the nation's stock of human and physical capital by encouraging investment. The initial impact of larger investment than would otherwise occur is to increase both national income and federal tax revenues through familiar multiplier effects. The longer lasting result is to enlarge the nation's capacity to produce goods and services, and also to enlarge the nation's ability to save for further investment. With appropriate monetary policies, a larger capacity to produce and a larger ability to save can be translated into higher national income and federal tax revenues. These "feedback" implications are ignored or trivialized by the Treasury/CBO revenue estimating method.

11. For example, in a 1982 study, the CBO concluded that small issue industrial revenue bonds increase the equilibrium capital stock of borrowing firms by only 0.3 percent.[11] This estimate is based on a theoretical cost-of-capital model that is entirely innocent of empirical verification in the context of tax-exempt financing. I suspect that many users of small issue industrial development bonds would find this 0.3 percent estimate ludicrous. For many borrowers, the availability of tax-exempt financing makes the difference between going ahead with the project, radically pruning the project, or cancelling it altogether. In any event, I suspect that the current Treasury/CBO revenue estimates make no allowance for even a

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[11] CBO, How Changes in Fiscal Policy Affect the Budget: The Feedback Issue, June 1982, p. 61.

trivial feedback effect.

12. In the third place, the Treasury/CBO method partly ignores the fact that smaller interest payments by users of tax-exempt financing mean smaller tax deductions by those individuals and firms. Smaller tax deductions in turn mean higher federal revenues. This connection is correctly reflected in the revenue cost estimates for tax-exempt mortgage bonds. However, it is ignored for small issue industrial revenue bonds on the assumption that industrial users simply lower their prices to reflect the interest rate saving.[12] There is no empirical basis for this assumption.

13. All in all, it appears likely that the Treasury/CBO method vastly overstates the federal revenue cost of "nongovernmental" tax-exempt bonds.[13] Indeed, if the Treasury's goal is to raise revenue, it might better eliminate tax-exemption for "governmental" bonds,[14] since they are likely to generate far smaller feedback effects, and they do not reduce the federal tax

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[12] CBO, Small Issue Industrial Revenue Bonds, September 1981, p. 43.

[13] The Public Securities Association will soon be publishing a critical re-examination of the Treasury/CBO revenue estimating methods.

[14] In its heart, the Treasury would like to do just that: "The exemption of this interest is inconsistent with a comprehensive income tax... [It represents an] outmoded understanding of federalism..." Department of the Treasury, Tax Reform for Fairness, Simplicity, and Economic Growth, November 1984, vol. 1, p. 135.

deduction for private firms and individuals. Conversely, from a pure revenue standpoint, the Treasury might well encourage certain types of "nongovernmental" tax-exempt financing, since their feedback effects probably make a net addition to federal revenues.

14. The Treasury claims that nongovernmental tax-exempt financing represents an inefficient way of achieving state and local goals and contains a "wedge of waste":[15]

> The Federal subsidy provided through tax-exempt bonds is inefficient because the subsidy is filtered through high-income investors. Because part of the subsidy is captured by these investors, the revenue loss to the Federal government is approximately 33-50 percent higher than the benefits received by the borrower.

The "wedge of waste" argument is overstated. To begin with, the federal government does not propose to replace tax-exempt financing with less "inefficient" federal subsidies. Moreover, the supposed inefficiency should be compared with the administrative costs of running explicit subsidy programs. In recent years, the yield spread between high-grade municipal bonds and AAA corporate bonds has been about 250 basis points. Suppose that as much as 40 percent of this amount, or 100 basis points, represents additional benefits captured by high-income investors.[16] It is most unlikely that state and local governments could achieve their goals with explicit subsidy programs entailing administrative costs of only 100 basis points (1 percent) of the capital funds disbursed.

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[15] The President's Tax Proposals to the Congress for Fairness, Growth and Simplicity, May 1985, p. 283.

15. The Treasury's contention that "nongovernmental" tax-exempt finance distorts investment decisions is fatuous. One man's distortion is another man's incentive. Even under the President's tax plan, the Federal tax code will contain important incentives/distortions--for example preferential treatment of oil income. The question is not the continued existence of incentives/distortions in the U.S. economy. They will persist even if tax reform is enacted wholesale tomorrow. The real question is whether state and local governments can use tax-exempt financing to carry out their vision of appropriate public goals.

16. Why is the Treasury pursuing this misguided proposal? Is the Treasury really counting those fictitious revenue gains? Is the Treasury genuinely concerned about "spoiling the market" for municipal debt? In light of mismanaged federal programs right here in Washington, can the Treasury really complain about the "wedge of waste" or the "distortion" of investment in Portland or Peoria? Or does the Treasury simply believe that one good whack at state and local governments, namely denial of the tax deduction, deserves another--denial of tax-exempt financing?

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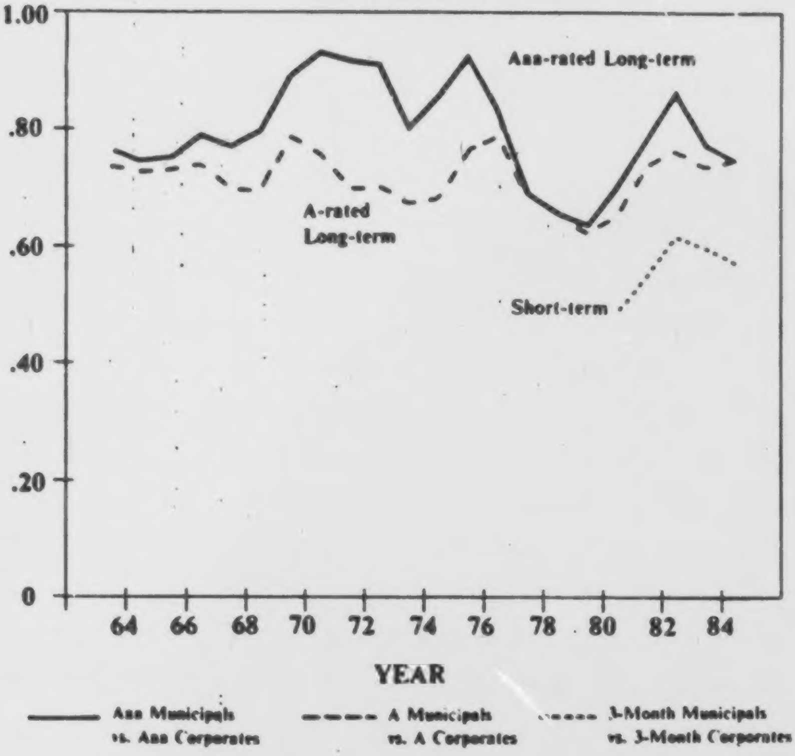
16. Under the President's plan, the top individual tax rate will be 35 percent and the next individual tax rate will be 25 percent. If the taxable bond yield is 10 percent, and if 25-percent bracket taxpayers are the marginal purchasers, then the equilibrium yield on tax-exempts would be 7.5 percent. A 7.5 percent tax-exempt yield would give 35-percent bracket taxpayers a "bonus" of 100 basis points--a "bonus" in the sense that, for them, a 6.5 percent tax-exempt yield would be equivalent to a 10 percent taxable yield. The 100 basis point "bonus" (which is probably about the same under today's tax rates) represents the inefficiency loss complained of by the Treasury.

CHART 1
Ratio of Tax-Exempt to Taxable Interest Rate
1963 - 1984



SOURCE: Moody's Municipal and Government Manual and Moody's Industrial Manual.

NOTE: 3-month ratio not available before 1981. 1984 data through August.

Source: Michael D. Hernandez and Darcy Bradbury, An Analysis of the Tax Exemption for State and Local Debt, Kidder, Peabody & Co., September 1984, p. 10.

The CHAIRMAN. Thank you very much.

Mr. Hughes, on page 2 of your statement you say, "What is nongovernmental about investing in environmental cleanups" and what not. Finally, "What is nongovernmental about stimulating investment in economic growth that creates jobs and greater productivity in this country rather than overseas?"

I want to come back again to the question I posed before, What kind of use in your judgment would be beyond the parameter of a municipal bond that is simply not in any way, shape, or form connected to what Government ought to be doing? Or is everything within that purview?

Mr. HUGHES. I am glad you asked, Senator. In spite of the distinguished gentleman on my left, we do not advocate that tax-exempt financing be used for everything. If I may, I would like to cite some specifics from our own experience in the New Jersey Economic Development Authority. We are the largest single issuer of industrial development bonds in the United States. We have aided thousands and thousands of projects, and we have turned down hundreds and hundreds. Let me give you some specific examples.

We encounter frequent paper transactions—someone wants to sell his plant, move to Florida, take tax-free paper and go away. We turn him down cold. That is not a proper use of tax-free financing.

A Fortune 500 company came to us not too long ago wanting to build a $40 to $50 million project, and because there is no capital expenditure test on the issuance of up to $1 million in IDB's, they wanted to finance $1 million of a $50 million capital expenditure with an IDB. We turned them down cold. They didn't like that. They came to the meeting and protested and said, "Everybody else does it." We said, "We don't do it at this Authority," and they went away. The project was not built with tax-free funds.

I have had occasion where an affluent lawyer, or an affluent doctor in an affluent community would call and wish to build a bigger and better office, and we turned them down. There are all sorts of things.

The CHAIRMAN. What is the basis upon which you turn down a request to build a factory that will provide jobs, and the point of it is jobs? And how do you decide to accept?

Mr. HUGHES. Well, first of all, Senator, by definition section 103 of the IRS Code indicates there must be a public purpose behind using the tax-exempt feature.

The CHAIRMAN. Well, earlier one of the witnesses said the provision of jobs is a public purpose.

Mr. HUGHES. That is correct. That is correct, and that is a public purpose, or the creation of ratables, particularly in a community that may need them. And we will not use tax-free financing for a project that does not fulfill one of those public purposes—or retain jobs; that has not been sufficiently emphasized today. We frequently find an applicant will come and say, "I've got to close down. I just can't compete. I've got to modernize my plant. I cannot pay prime-plus-two or three or four. But I can pay prime-minus-250 basis points," whatever the market may be. "And if I can get this tax-free financing, I can keep my plant going. I can modernize it, and I can save those jobs." That is a large part of what we do.

The **Chairman**. And that is a legitimate public purpose?

Mr. **Hughes**. In my opinion it is, sir.

The **Chairman**. To come back again, in terms of the production of jobs, creation of jobs, or the saving of jobs, what is not a legitimate public purpose where indeed there are jobs at stake?

Mr. **Hughes**. Do you mean if the jobs are going to go away and our help is turned down?

The **Chairman**. No, where you are going to create jobs.

Mr. **Hughes**. If our assistance is necessary to create those jobs, I would suggest that is a valid public purpose.

The **Chairman**. Well, then, there is almost nothing that is not a valid public purpose in terms of the creation of jobs.

Mr. **Hughes**. Well, sir, our assistance is not always required to create those jobs. Again, if an affluent company in an affluent community wants to make this a minor part of the financing, and we have the feeling that the financing is not necessary, then we do not go along with it.

The **Chairman**. You are distinguishing—and I can't remember if it was Senator D'Amato or who—on the ability of the company to produce the funds itself. And if they do, then you don't think it is a public purpose, or at least you may think it is a public purpose but you don't involve yourself; whereas, if they can't produce the funds, you do.

Mr. **Hughes**. It isn't just ability, it is willingness—willingness and desire. There is a distinction between what a company "can" do and what they "will" do. Some companies can build a plant, but without the proper incentives they won't.

The **Chairman**. Let me ask you a specific: Was Meadowlands built privately?

Mr. **Hughes**. I believe it was; it was not built with IDB's, sir. I believe it was built with——

The **Chairman**. I didn't think it was, nor was the Capital Center here.

Mr. **Hughes**. It was built with State funds, if I am not mistaken, but not industrial development bonds.

The **Chairman**. Is the building of sports facilities in your mind a legitimate public purpose?

Mr. **Hughes**. A public sports facility? Yes, sir.

The **Chairman**. Why?

Mr. **Hughes**. Because it benefits the entire populace, it creates ratables for the community, and obviously it creates jobs.

The **Chairman**. Would the building of an equivalent of a Disneyworld be a legitimate public purpose?

Mr. **Hughes**. Well, Senator, with all due respect to your academic questions, as you know, industrial development bonds are limited by their capital-expenditure test, and you just can't build something of that magnitude and that size with certain exempt-activity incentives.

The **Chairman**. I understand that, but I want to get to the definition of "public purpose." I can get down to smaller issues in a moment, but I am curious about the definition of a public purpose.

[Bell rings.]

Mr. **Hughes**. Does that mean I don't have to answer?

The **Chairman**. No. [Laughter.]

Mr. Hughes. Well, sir, Congress has defined what is a public purpose, and redefined it, and tightened it over many, many years.

The Chairman. I want your answer on what is a public purpose, because I am afraid what we are going to come to if Congress doesn't define it tightly is that anything a local government wants to call a public purpose is going to be a public purpose.

Mr. Hughes. No, sir, it is not anything the local government wants to define it. They must operate within the restrictions of the IRS Code.

The Chairman. I understand that. We write the IRS Code—hopefully we haven't give up that authority yet. Some think we have. But I am trying to decide whether we ought to limit the definition of public purpose more strictly.

You would allow, I think, other than where you choose to exercise your judgment not to do so, almost any job creation as a public purpose.

Mr. Hughes. Job creation that is made possible only through the assistance of the tax-exempt financing.

The Chairman. Senator Chafee.

Senator Chafee. Thank you, Mr. Chairman.

I would like to ask Mr. Hughes about massage parlors. Let us take one that is open to all, there is no discrimination, and it promises a lot of employment for the community. A public purpose?

Mr. Hughes. Obviously not, sir. No, sir.

Senator Chafee. Why obviously not?

Mr. Hughes. Well, obviously it is not a public purpose now, because Congress has said it is not a public purpose. If you are asking me for a subjective, personal opinion of whether I would approve a massage parlor, we never did in the State of New Jersey.

I could make a case that in a certain tourist area—and I am talking about, let's say an ethical massage parlor, if you will, then it is a very important——

Senator Chafee. Well, we are talking strictly ethical massage parlors. [Laughter.]

Mr. Hughes. Thank you. I wouldn't know the difference, myself. [Laughter.]

The Chairman. I will make sure you get a copy of that answer for the record. [Laughter.]

Mr. Hughes. Can you note it for my wife, please?

Senator Chafee. No, it is very ethical, where everyone can feel free to use their Mastercharge. Why isn't it a public purpose? It is going to employ a lot of people and perform a service.

Mr. Hughes. Senator, I suggest it could be, particularly in a tourist area which is an important part of the local economy. I just don't wish to think——

Senator Chafee. In other words, isn't the answer to all of these questions, "There is no limit"? If anybody can read some employment into it, go to it?

Mr. Hughes. If there are perceived abuses, and there are, apparently, then I suggest there are remedies for those perceived abuses. If people are ripping off the Social Security system, then there are remedies for that. There are remedies to correct all sorts of abuses. Congress has already, in 1982 and again in 1984, made corrections. And I suggest that is the way to go.

Senator **Chafee**. Well, what do you say to the argument made by Dr. Galper, in which he says "The subsidy provided by tax exemption is a particularly inefficient one"? Then he goes on to take the example of:

> One-third of the benefit of tax-exempt financing may go to financial intermediaries and high-bracket investors rather than to the ultimate borrower. The CBO has estimated that even less, in some cases only one-fourth, of the federal revenue loss subsidizes intended beneficiaries.

Mr. **Hughes**. I suggest Dr. Hufbauer answered some of that. The figures are based on marginal tax rates which are no longer realistic or effective. There is an assumption made that these bonds are bought by high tax brackets. I think other studies indicate that much lower tax-bracket individual investors buy them. And I emphasize strongly that we look where these bonds are bought. These are small-issue IDB's, bought locally by banks in small numbers that are not competitive in the public markets.

Senator **Chafee**. You say in your statement, "Virtually all studies minimize this causal effect." In other words, you are talking about the question of whether the issue of nongovernmental bonds pushes up the interest rates on traditional general obligation bonds. Then you say, "Under the small-issue IDB program, for example, our membership survey shows that more than 80 percent of these financings are privately placed. Consequently, any effects on the public credit markets are almost negligible."

I missed a beat in there. Why, when they are privately placed, don't they affect the public credit market? I mean, people who take private placements are aware of what is happening in the public credit market; they are not just operating in a vacuum.

Mr. **Hughes**. The bond buyers of the typical small-issue IDB are not using funds that alternatively would be placed into the public market; these are commercial loans provided by the commercial lending department of the bank. They are not bank investment funds. And I state that from empirical discussions and from personal experience in the past. These moneys, if they go away from small-issue IDB's, will not suddenly become available for investing in the public market.

Senator **Chafee**. What do you say to that, Dr. Galper?

Dr. **Galper**. I say that, if they are lending more in one form, it is less available for them to lend it in another form.

Senator **Chafee**. I would think so, too.

Dr. **Galper**. Yes.

Senator **Chafee**. I have trouble following your argument, Mr. Hughes.

Dr. Minarik.

Dr. **Minarik**. I was just going to say, Senator Chafee, there are other borrowers who borrow both from commercial lenders and in the markets, and they would be the ones who would help to determine that the lesser availability of funds in the commercial markets would drive up rates in the public markets.

Senator **Chafee**. I would think so, too.

I thank you, Mr. Chairman.

The **Chairman**. Senator Long.

Senator **Long**. No questions, Mr. Chairman.

The **Chairman**. Senator Mitchell.

Senator **Mitchell**. Mr. Chairman, I commend you for the approach taken in having affirmative and negative arguments made here; I think it is very useful. So, in the spirit of that, just to stimulate a little discussion here—everybody has been talking with Mr. Hughes—with Dr. Galper and Dr. Minarik, the question is whether or not the creation of employment is a legitimate public purpose, it seems to me.

Don't we try, throughout our economy and the structure of government to encourage employment, recognizing that making gainful employment to all who wish to work is one of the most important needs in our society and indeed any society?

Dr. **Galper**. The determination of what is and what is not a public purpose is clearly part of this issue. But there is another part of this question; namely, to what extent should a Federal subsidy be used for promoting what is a State and local purpose? If in fact State and local governments want to creat jobs in their own communities by providing subsidies to firms to enter into those communities, that's perfectly fine. Why should the Federal taxpayer pay that subsidy? That's the question that hasn't been addressed.

Part of the issue, indeed, is what is and what is not a public purpose; but part of the issue is what's a Federal purpose and what's a State and local purpose? There is nothing to prevent State and local governments from providing whatever subsidies they want to any firm to locate within their borders; the question is, Why should the Federal taxpayer pick up the burden?

I would say that if you do want to create jobs, there are much better ways of doing it than creating artificial distinctions among categories of borrowers where some are able to qualify for tax-exempt financing and others are not. I say it is a terribly inefficient way of doing it. If the State of New Jersey wants to give money out of its own coffers to attract a firm to locate in the State, fine, more power to them.

Senator **Mitchell**. But you are acknowledging, then, that there is a valid public purpose; you are just saying this is an inefficient way to accomplish it, and it's best done at the local level.

Dr. **Galper**. And it may not be a national purpose to create jobs within the State of New Jersey, specifically, especially if those jobs are at the expense of New York or Pennsylvania.

Senator **Mitchell**. But does the law say "national," or does it say "public?"

Dr. **Galper**. Are you asking what the law says or what I think is an appropriate definition?

Senator **Mitchell**. I am asking what the law says.

Dr. **Galper**. Well, I guess I don't know what the law says.

Senator **Mitchell**. I will ask Dr. Minarik this question:

As I understand it, the President's proposal would deny tax-exempt financing to a municipally owned solid waste disposal facility if it is managed by a private company. The municipal government that owned and managed a solid waste disposal facility would be able to utilize tax-exempt financing. In your judgment, is that an appropriate distinction? And how does that square with your argument that tax-exempt financing is inherently an inefficient way to subsidize public purposes?

Dr. **Minarik**. In my own opinion, Senator, if there is a management contract between a local government and a private management firm to run an operation that would otherwise qualify for tax exemption, then I don't see why the management agreement should disqualify the transaction from the tax exemption. It seems to me that the issues that Treasury is attempting to deal with here go deeper than that, and are the questions of the industrial parks and the other areas where localities are simply subsidizing private businesses to do what private businesses always have done and always will do.

Senator **Mitchell**. But let me ask you specifically, do you approve of the former case, in which tax-exempt financing is available for a municipally owned, municipally operated solid waste disposal facility?

Dr. **Minarik**. I would definitely agree with that.

Senator **Mitchell**. You would approve that?

Dr. **Minarik**. Yes.

Senator **Mitchell**. Do you disapprove in the situation where a municipality owns a facility and then contracts with a private company to manage it?

Dr. **Minarik**. I would not disapprove of the tax exemption in that instance.

Senator **Mitchell**. So in other words, you disagree with the President's proposal in that respect.

Dr. Galper.

Dr. **Galper**. I would like to note that if you look at figure 1 toward the end of my testimony, only 6 percent of all municipal tax-exempt financing in 1984 went to sewer disposal IDB's; so we are really talking about a relatively small piece of the problem, if that is the contention. It is very difficult to draw the line, I acknowledge this, between what is public and what is private in this area. We have investor-owned utilities which have to use taxable financing; we have municipally owned utilities which can use tax-exempt financing—the same activity, two different ways of financing. It is not an easy issue.

Senator **Mitchell**. Well, the existence of one anomaly in the tax laws is no justification for creating another.

Dr. **Galper**. No, no. That's right.

The **Chairman**. Senator Durenberger.

Senator **Durenberger**. Would someone else on the panel care to respond to the chairman's last question in terms of the job creation? It seems to me that the problem with using the retention or creation of jobs as a public purpose is the problem of shifting. One of you just said that New Jersey gets jobs at the expense of New York. Often it is the suburb that gets it at the expense of the big city, one part of the State gets it at the expense of another part of the State. Is there a standard measurement for jobs that assures you, when you make a decision on a jobs basis, that it is a net gain or a way to measure retention?

Dr. **Galper**. I would say for the purpose of tax-exempt financing, jobs would be a very poor definition for what constitutes public purpose.

Senator **Durenberger**. But if we wanted to use it, is there a standard measurement by which everyone can agree that there is a net job gain or a very specific demonstration of job retention that exists?

Dr. MINARIK. I don't think you can have such a measure, Senator. Could I say one thing, though? Every private investment and every private business involves employment. If job creation is a suitable rationale for a tax exemption, then theoretically all capital in the private sector of this economy could move to a tax-exempt basis, and we wouldn't have any capital in the tax base. So there has got to be something more than job creation there if this is going to make sense.

Mr. HUGHES. May I suggest, sir, two things? Dr. Galper referenced if New Jersey wants to create jobs, let the New Jersey people pay for it. May I suggest that the people whose jobs are created pay Federal income taxes, that the corporations who make the expansion and increase their profits pay Federal income taxes. This redounds to the benefit of the Federal Government; as I indicated in my tax reflows comments, there was a $3 billion reflow to the Federal Government as a result of these programs in earlier years.

Secondly, I would suggest that the shifting is not from one State to another, it is from the unemployment rolls to the employment rolls.

Senator DURENBERGER. Let me ask one of you to talk about the degree to which interest rates have been increased on clearly public-purpose bonds, the general obligation bonds, by the use of tax-exempt bonds in such a general way as to include this multiplicity of private purposes. How much in America have we increased the cost of general obligation bond financing? Does anybody know the answer?

Dr. GALPER. I don't think that is easy to answer. Gary Hufbauer cited a study which I did with a colleague several years ago which indicated a 13 basis point increase, and he said that more recent estimates would be a 2 basis point increase per billion dollars of additional tax-exempt financing.

At the time I made that estimate, a $1 billion increase was about a 15-percent increase in the volume of private purpose tax-exempt financing. Now, $1 billion represents about a 1½-percent increase in the total volume of tax-exempt financing.

One would expect that adding a billion in 1985 would be a little bit different than adding a billion in 1975. If we inflate for the scales, if anything our early estimates understated the extent of this. But even if we used the 2-basis-point figure which Hufbauer uses, and if you carry through some of his calculations, where he said there was something like a $400 million cost to bonds issued in the year 1983, I believe it was, if you look in terms of the stocks of bonds outstanding that implies almost a $3.5 billion increase in terms of the costs of financing for State and local government debt that is now outstanding. If you look over the lifetime of the bonds that would be issued in that period of time, in 1983, there would be about a $10 billion cost. So a few basis points here and there can really add up to a substantial amount of costs in terms of the stock of bonds outstanding and in terms of future interest rates on the entire payment stream over the lifetime of those bonds. So I think that is an important additional cost that is imposed on State and local governments.

Senator **Durenberger**. Dr. Galper, 15 years ago you wrote on what would be an alternative to this, which, as I recall, was that we in effect subsidize municipal bonds. Do you still throw that around as a recommendation?

Dr. **Galper**. Well, my view is that if we are to provide this so-called taxable bond option for municipal bonds, it should be done after the market is cleaned up, so that these private-purpose bonds don't get the same benefit of that type of subsidy.

The **Chairman**. Senator Symms.

Senator **Symms**. No questions, Mr. Chairman.

The **Chairman**. Senator Bradley.

Senator **Bradley**. Thank you, Mr. Chairman.

Let me welcome Mr. Hughes to the Finance Committee; all the panel members, but particularly Mr. Hughes. No offense to the other panel members.

On the job creation question, if you assume—and I am not sure that I do, but if you assume that job creation is the objective, one of the questions is, would not these jobs have been created even without industrial development bonds? Could you give me some sense of how you would answer that question, Dr. Galper, Dr. Minarik, and then Mr. Hughes? Or all of you? And also could you answer the question: Assuming the government should be creating jobs or subsidizing economic and social activities, is this the most efficient way?

Dr. **Galper**. Yes; you always have to answer that question relative to some benchmark. If you are saying: given a total amount of revenues that we were to raise by the tax system, if we decided to cut taxes in the form of or provide a subsidy in the form of tax-exempt financing as opposed to let's say individual rate cuts, would more jobs be created one way or the other way—if we have a revenue target that we are trying to achieve, I don't see how tax-exempt financing creates any additional jobs, because it does force the need to raise revenues elsewhere to offset the revenue loss.

Now, if you are saying that we are providing a tax cut, then the question is why do we want to provide a tax cut in this form as opposed to any other form?

I acknowledge that a tax cut, just like an expenditure increase, can create jobs.

Senator **Bradley**. Well, if you view this as a tax cut, it is a tax cut for whom? I mean, what income level gets the tax cut?

Dr. **Galper**. It is a tax cut that is shared between the high-income individuals who own the tax-exempt bonds and individuals who are able to finance with tax-exempt financing and thereby lower their interest rate. So it is shared between those two groups.

Senator **Bradley**. Dr. Minarik.

Dr. **Minarik**. I would just expand on that a little bit, Senator. It seems to me that if this kind of an investment subsidy creates jobs, then any investment subsidy can create jobs. What happens, however, with this kind of a subsidy is that the benefit, the job creation, takes place in a particular distinct location, and you can point to it and say, "This factory is the effect of this particular kind of subsidy." If you go to an alternative subsidy like the investment credit, you can't go to a location and say that "this shovel hit the ground here because we had an investment credit and not for any other reason."

And then of course I think Harvey is absolutely right; you have to have a benchmark. And if you are talking about a balanced budget or at least a no-greater-deficit model here, the investment that takes place in one location has to displace investment that would have taken place someplace else.

The photo-opportunity advantage of the IDB is that you can point at the job that was created, but nobody can find the jobs that weren't created elsewhere.

Senator **Bradley**. So it is the concentrated specific benefit versus the diffused benefits?

Dr. **Minarik**. That is correct, Senator.

Dr. **Galper**. The problem of any tax preference.

Senator **Bradley**. Mr. Hughes.

Mr. **Hughes**. I prefer the term "incentive" to "subsidy," Senator, and that is what we provide; the incentive to build what otherwise would not be built, to make happen today what might be deferred or never done.

I agree with the idea that it is very easy to specifically relate the jobs, and we do that, and most responsible issuers of industrial development bonds do the same.

We in New Jersey, as you know, have a tight inducement requirement; we must be convinced the project will not proceed without our assistance. We then require the applicant to indicate to us how many jobs he will create or maintain or save; then we monitor it very, very closely, and can relate, and we can document, 100,000-plus jobs from the existence of the Authority.

Senator **Bradley**. Well, as I drive around the State and see where the EDA signs are, they are frequently in areas that are major growth areas of the State. Is it the contention that without EDA financing those shopping centers or those other office buildings would not have been built?

Mr. **Hughes**. Most of those projects that you see of that nature are in targeted communities, Senator, I beg to differ with you. We will do manufacturing projects and research projects and certain targeted projects in many municipalities.

The **Chairman**. They are what kind of projects, did you say?

Mr. **Hughes**. I'm sorry, sir?

The **Chairman**. You said targeted communities?

Mr. **Hughes**. Targeted communities. In New Jersey we have a targeting policy. We will do manufacturing, research, agricultural, certain specific projects anywhere in the State within the law. Other types of projects such as the Senator is referring to—speculative office buildings, commercial, and so on—we will only do in a "targeted community" that has high unemployment, et cetera, with certain waivers or exemptions for hiring the disadvantaged and things like that.

Senator **Bradley**. Dr. Hufbauer.

Dr. **Hufbauer**. Could I just use a few minutes to try to rebut what Harvey Galper said on the spread?

Senator **Bradley**. Well, could you not do it on my time?

Dr. **Hufbauer**. Surely. Pardon me. [Laughter.]

I have very little to add to what Mr. Hughes said on the question.

The **Chairman**. There was an interesting bidding situation in Oregon with 1,100 jobs, two Oregon ports bidding for them and a port in Louisiana. They went to Louisiana. They are going to build oil modules for the North Slope. My hunch is that that job was going to go someplace, regardless of whether there was any kind of an industrial-development enticement. They chose where they got the best deal, I understand that, but I find it hard to believe, considering how much long-term involvement there is in capital, other than what you may get from an IDB, that you would invest in a major facility solely because of IDB financing.

Again, you can comment, but my experience in Oregon is that it is a question of "can we steal a factory from Denver that otherwise would maybe go to Detroit?" but they are going to leave Denver in any event. They are going to go someplace, and they are going to go someplace with or without Government help.

Dr. **Galper**. Once they are going to go, they will then try to get the best package they can.

The **Chairman**. Well, I understand that, and that is a perfectly good business decision. But in terms of job creation, I'm not sure that the decision to build—not build in New Jersey versus building in Oregon but to build—is enticed by the development bond.

Dr. **Galper**. A study done by the Joint Center at Harvard and MIT came to exactly that same conclusion, Senator.

The **Chairman**. Mr. Hughes.

Mr. **Hughes**. There is too much emphasis on relocation, Senator. Our studies indicate—and it is an extensive survey that we have undertaken—that less than 12 percent of IDB projects involve relocation. People just don't say, "I'm going to move to Michigan because they have an IDB program."

The **Chairman**. Most of them involve new construction, I understand that, but what I want to know is would the construction happen without any IDB inducement from anybody?

Mr. **Hughes**. It is our contention the construction would not happen "at this time, in this place, in this magnitude." The IDB availability makes the difference.

The **Chairman**. "In this place," you mean being New Jersey?

Mr. **Hughes**. No, I didn't mean New Jersey, obviously. In wherever it happens to be. I was not speaking parochially there. It makes the difference. It makes it go right now—in this magnitude; that's the other thing. Somebody may have to expand, but with the availability of incentive financing he will do it quicker and bigger.

The **Chairman**. Senator Chafee.

Senator **Chafee**. Two plants, side by side. One has been run in an efficient manner. Both making widgets. One has managed, through caution in the disbursement of his funds and watching his inventory, to survive. The plant next to it announces to you, Mr. Hughes, that absent an IDB from you they will close, losing 150 jobs. With the IDB's, they will remain open. So you give them the IDB under the illustration you previously gave them.

What does that do to the fellow next door? Is there any equity here? He might get that widget business if the other fellow had gone out of business; but, because of your generosity, his competitor remains strong, getting cheaper financing for inventory and for machinery and equipment than the good fellow does. Is that fair?

Mr. HUGHES. And if his competitor overtakes him, the second fellow can come back to us and request the same assistance. We are an equal rights provider on that.

Senator CHAFEE. Well, now we've got a really good question. [Laughter.]

I see. And there are unlimited possibilities here. And I think the first fellow, the good fellow, was a sucker not to have come to you in the first place and plead poverty and say he needed some new machinery and equipment. If he has the chutzpah to do it, he says he is going to move out to Georgia unless you help him. He would get the deal, wouldn't he?

Mr. HUGHES. Not necessarily. No, sir. I suggest our requirements are a little stricter than some people have implied.

Senator CHAFEE. Thank you, Mr. Chairman.

The CHAIRMAN. Senator Mitchell?

Senator MITCHELL. Well, Mr. Hughes, what evidence do you require of inability to obtain private financing? How do you make that determination?

Mr. HUGHES. Again, I believe strongly, that private activity bonds in general are defensible and should not be taxed; but to cite empirical evidence, I am more comfortable wearing my New Jersey hat, if you will. In the State of New Jersey we ask an applicant three questions: No. 1, "What are your plans for increasing employment, rateables, or improving the economy of New Jersey?" No. 2, "What are the alternative means of financing this project available to you?" And No. 3, "What will you do if we do not approve this project for you?"

I must admit, though, like the IRS and certain other collectors of data, that we are somewhat dependent on an applicant's truthfulness; however we don't accept everything at face value. We assign a team of investigators, a project team; we visit the site; we investigate these people. And as I indicated earlier, we turn down literally hundreds of them. So the applicant must affirm to us, and sign, and have notarized all sorts of things that he is doing truly what he says he will do, and indicate the number of jobs he will create, which we monitor.

Senator MITCHELL. In your judgment would it ever be appropriate this type of financing to companies that could obtain financing elsewhere.

Mr. HUGHES. We do not provide financing for companies that could obtain financing elsewhere.

Senator MITCHELL. Under any circumstances?

Mr. HUGHES. With the exception of the "exempt activities"—pollution control and waste resource recovery, et cetera.

Senator MITCHELL. Do you use IDB's in attracting industry to New Jersey in competition with other States?

Mr. HUGHES. Senator, I go back to the fact that people don't come to us and say, "If you will give me an IDB I will come to New Jersey," people make, in the real world, the decision that they have to expand or move for other reasons. And sure, I get people from other States calling up frequently saying, "I'm coming to New Jersey," or "I've made a decision to move to the east coast; do you have incentive financing available to you?" And my question is always the same: "Is this necessary to make this project go and to hire these people?" not "to lure you from Michigan." I think, with all due respect, that is a red herring, that people are using these things to transfer jobs and people all over the country. That simply isn't the case. We are not getting a lot of people out of California to come to New Jersey because we have IDB's.

Senator **MITCHELL**. Don't you get situations in which an industry is trying to extract something from one State, the State it is in, and shops around and sees what it can get elsewhere then comes back to the State it is in and says, "Look here. If I go to New Jersey or Pennsylvania, or South Carolina, I can get X, Y, and Z, so you'd better give me something?"

Mr. **HUGHES**. Of course. That is the case. But IDB is only a small part of that puzzle. Every company seeking to move seeks all the advantages they can get.

Senator **MITCHELL**. But I am not talking about companies that seek to move; I am talking about companies that seek to stay, but on better terms than they now have.

Mr. **HUGHES**. The same argument. The company will say, "I am going to move to Georgia unless you provide attactive financing for me." And I say to them, "We'll give you the same financing Georgia will give you," or whoever it may be, "no better, no worse." You know, IDB's are not a competitive tool, as such; they are just a necessary ingredient for expansion purposes.

Senator **MITCHELL**. Thank you.

Thank you, Mr. Chairman.

The **CHAIRMAN**. But if Georgia couldn't give an IDB offer, then New Jersey wouldn't have to match the same offer.

Senator Durenberger.

Senator **DURENBERGER**. Would any of you care to comment on the degree to which either the tax incentive or the tax subsidy, whichever we want to call it, through tax exempts can be seen as having some kind of a needs-test to it? As we look across this nation, and we are dealing with so-called scarce nationally collective resources, can we be sure that in helping State and local governments carry out certain important public purposes, those scarce national resources collected from 232 million people are going to those States or those localities or those purposes which need this $44 billion or $39 billion or $21 billion subsidy most? Does the current system of tax emption on these bonds have in it any means of needs-testing that allocation, that incentive, that subsidy?

Mr. **HUFBAUER**. Senator, if I could take a brief stab at that, I think the cap—the $150 per capita limit, soon descending to a $100 per capita limit, begins to go in the direction that you are talking about. What this cap says to the State is that it must use some prudential judgment as to how this scarce resource ought to be allocated within the State. And I think the States and localities do take a serious view of their responsibilities. They don't just toss tax-exemption around willy-nilly. The cap provides a meaningful and useful type of test to ensure a wise use of these tax-exempt bonds.

Senator **DURENBERGER**. Dr. Minarik.

Dr. **MINARIK**. Senator, I think that is putting the best possible face on the situation. I think the next question is, looking at it from the Federal level, every State gets $150 per capita and $100 per capita after 1986: Is that the appropriate way to allocate the ultimate amount of lending ability among the states? And if the Federal Government feels compelled to give that out on a per-capita basis, how can we be sure that the States and localities are not passing out their money on a per-capita basis as well? They may very well be targeting their allocations of IDB availability very carefully, or they may have the same political constraints that the Federal Government has and be passing it out on the same uniform basis, spreading the butter all over the bread, just as we do.

Dr. **Galper**. It illustrates the problems when you really have an expenditure program. We would have to ask that same question if it were a direct expenditure program, where we looked at the revenue loss estimated at something like $10 billion for the year 1983 and to double to $20 billion by 1990, and so we want to spend $20 billion. How should we make decisions on how to allocate that? What criteria should be applied?

I don't have any easy answers to that, but it is clear that absent some criteria the opportunities for indiscriminate use are widespread.

Senator **Durenberger**. Mr. Hughes, before you reply—and I need your reply—it seems to me we spend something in the neighborhood of $150 billion a year—it may be more—in aid to State and local governments. A large part of it is needs-tested through the Medicaid Program and AFDC and food stamps and housing. So a lot of it is needs-tested. But in this particular area I don't see the needs testing. Maybe you can tell me that there is a way to do it.

Mr. **Hughes**. Well, the need to fill a public purpose is the test that we go by. I may not understand your question, Senator.

Senator **Durenberger**. No, no. You are getting to where I am headed, which is that maybe it is impossible to needs test this other than by agreeing that this is a genuine public purpose that deserves a national incentive or a national subsidy.

Mr. **Hughes**. I would so contend.

The **Chairman**. Senator Bradley.

Senator **Bradley**. Sorry, Mr. Chairman, I missed that last line of questioning. Could you summarize it for me, because I wanted to ask about public purpose.

Senator **Durenberger**. Yes. We were exploring whether or not this program, No. 1, is at all needs tested. And if it is not, can it be, or is it practical to consider it? And I think the consensus might be to forget about trying to needs-test a program like this. We should concentrate on a clear public purpose, and then decide whether the national government ought to finance that purpose in this way as opposed to other ways.

Senator **Bradley**. Well, my question is what does the panel have to offer us as to how we could define "public purpose" in a way that makes sense. Even the President's bill provides for tax-exempt financing for some general obligation bonds. But it can then be a fine line between public and private sewers, or whatever, and some public purposes. The question is: How would you suggest we define "public purpose"? If we agree that we are not going to give it to General Motors to put a plant where it would put it anyway, how do we define "public purpose"?

Dr. **Galper**. The Treasury tries to do so by ownership. I understand the reason for that; it makes some sense. The difficulty, of course, is there is a such a variegated pattern across the Nation with respect to ownership of various types of facilities.

Senator **Bradley**. How would you do it? How would each of you do it?

Dr. **Galper**. I would try to use ownership, but with more liberal definitions of outside management of the facility still qualifying for tax-exempt financing.

Senator **Bradley**. But how would you do it with ownership?

Dr. **Galper**. I would say the facility would have to be publicly owned to be tax-exempt financed, and that if it were managed by a private entity but publicly owned, that that would still be a reasonable test.

Dr. **Minarik**. Senator, I am not an expert on the legal language here, but it seems to me that restriction to general obligation can be somewhat productive, unless somebody can suggest in the otherwise. It seems to me that if the governmental entity itself is willing to put its faith and credit behind the bond, if it is willing to be left holding the bag if the enterprise does not work out and there is a loss, that suggests to me that there is a public purpose there. But a lot of these other forms of financing where the locality or the state is not willing to put its faith and credit behind the bond, that seems to be a suggestion that in fact the purpose is not a general public purpose.

Senator **Bradley**. What is wrong with that argument?

Mr. **Hufbauer**. Senator, I think there are two problems with that argument. First, it tends to force State and local governments to bring more activities the narrow definition of government, to enlarge their bureaucracies beyond what they otherwise would want to. Some of the examples given earlier in the hearing of governments getting into the airport management business tell the story.

But more fundamentally, I think this line of argumentation doesn't give proper respect to our Federal system. I think in our federal system one can have States like Wisconsin, which have a very broad view of public purpose, and one can have States like Mississippi or Alabama which have historically had a much narrower view of public activity.

It seems to me that the appropriate way for the Federal Government to deal with a problem, what it perceives as a problem, is dollar-type limitations, allowing great latitude at the State and local level as to how dollar limitations will be used.

One footnote to that: If the Federal Government is going to start putting dollar limitations of this sort, at least they ought to be escalated to reflect the growth in Federal debt. There is a great difference in the ability of the Federal Government to use debt for its concept of public purpose and the ability of State and local governments.

Senator **Bradley**. So you are not going to take a stab at defining "public purpose" at the federal level?

Mr. **Hufbauer**. I would be quite deferential to State and local government definitions.

Senator **Bradley**. Mr. Hughes, do you want to say anything?

Mr. **Hughes**. Do I want to take a stab?

Unfortunately, the term "private activity" has become a pejorative one, and this is a sudden iron curtain they have slammed down between what used to be overlapping public purposes. I would prefer to see a whole new term invented like "public benefit bonds" or "public interest bonds" or something like that. And it seems to me it is in the national interest to provide for affordable housing for low-income people, to provide for toxic cleanup, to provide for education. I can't establish those important criteria.

Senator **Bradley**. But you see, the problem the committee has if we take Dr. Minarik's suggestion, is that you've got a big pool here that is all general obligation, and if you don't back with full faith and credit it doesn't get tax-exempt status. Then you have Dr. Hufbauer's position which is, let's keep it the way it is, with maybe a little dollar limitation. And if you are the committee saying maybe we want to do something that has some public purpose—obviously hospitals, et cetera—well, how do we do it? I mean, the reason we have people come before us is to give us some ideas. I think that's what we want. We know your positions; we are looking for some advice.

I am not directing that at any one member of the panel.

Mr. **Hughes**. I was just going to conclude my comment, Senator, with what I think is a more appropriate conclusion to what you just said. Ranking the national public purposes, besides the safe and clean environment, I would maintain that the creation of jobs and a healthy economy ranks right up there among all those other things. And if you are going to do that, and if you believe that is in the public interest, then this is the way to go.

The **Chairman**. Senator Long.

Senator **Long**. No questions, Mr. Chairman.

The **Chairman**. Senator Grassley.

Senator **Grassley**. No questions, Mr. Chairman.

The **Chairman**. Just one quick one, Mr. Hughes. I take it New Jersey would not in any way offer the inducement of industrial bond financing to General Motors to locate the Saturn plant in New Jersey?

Mr. **Hughes**. It is an academic question, Senator. There is a $10-million capital expenditure test on projects.

The Chairman. So you wouldn't offer them anything, even up to that, in the inducement of getting them?

Mr. **Hughes**. I wouldn't go so far as to say that, Senator. [Laughter.]

The **Chairman**. Oh. You mean to say there are companies that might have difficulty getting financing?

Mr. **Hughes**. I'm sorry?

The **Chairman**. Well, you said you distinguish between companies that can get financing elsewhere and those that can't. And in that case, I assume your decision would be that GM would have trouble getting financing, and therefore would fit within your criteria.

Mr. **Hughes**. Hypothetically speaking, if the project you were talking about were under $10 million—and it's not, so it is not a point—but if it were under that, and our assistance was necessary to make that project proceed, we would provide it.

The **Chairman**. Any other questions?

[No response.]

The CHAIRMAN. If not, gentlemen, thank you very much.

Mr. HUGHES. Thank you, Senators.

The CHAIRMAN. Now we will conclude with two people who have been quite patient, Donald Lubick and Lindsey Miller-Lerman, testifying on the subject, the very specific subject: Is it constitutional to tax interest on State and local bonds?

It has been a long time since Mr. Lubick has been before us. We spent many happy hours with him, at least happy for us—I don't know if they were happy for him—when he was the Assistant Secretary for Tax Policy. He would have to sit through all the markups and on an instant's notice defend every position of the administration even on obscure points that we had never had testimony on, and he did it with great aplomb and diligence.

We are delighted to have you back. Why don't you go first, Don?

STATEMENT BY DONALD C. LUBICK, PARTNER, HODGSON, RUSS, ANDREWS, WOODS, & GOODYEAR

Mr. LUBICK. Thank you, Mr. Chairman, Senator Long, and members of the committee.

I know, having heard my views before on taxation of things like timber and energy and fringe benefits, you probably have some reservations and trepidations. But I would like you to know that I didn't do very well in taxation in law school but I did do pretty well in constitutional law. So I approach the subject with one simple proposition, that there is no reasonable doubt that a nondiscriminatory tax on all income may include income from obligations of State and local government within its ambit.

The history of this issue I think makes this clear. There were two cases prior to the 16th amendment of great significance in this area, involving the relative ability of the States to tax obligations or impair the immunity of the Federal Government, and vice versa. The first was *Collector* v. *Day,* which was the case which held that it was unconstitutional for the Federal Government to tax the salary of a State judge, on the ground that that impaired the ability of the State by increasing the cost of its judicial function. Presumably they could pay their judges less if they didn't have to pay taxes.

Second, the leading case and perhaps the most important one which is relied upon by persons who suggest that there may be a constitutional problem, is the famous case of *Pollock* v. *Farmers Loan and Trust.* In that case the Supreme Court held a Federal income tax unconstitutional for, among other reasons, the fact that it attempted to tax the income from obligations issued by State and local governments. And that was held to be a burden on the borrowing power of State and local governments. In other words, if the interest on these bonds were taxable, the State and local governments would have to pay a higher rate, and therefore the court held that that economic burden was a violation of the immunity of State and local governments from taxation by the United States.

Now, since that time both of those cases have been overruled—*Collector* v. *Day* expressly by the Supreme Court in a later case, the *Graves* case, which specifically held that the Federal Government could tax the salary of a State officer, and the *Pollock* case by the 16th amendment, which in its express terms stated that Congress can lay a tax upon income "from whatever source derived." That language was adopted after much debate, which indicated that this language could lay open the possibility of the Federal Government taxing interest from State and local bonds.

Moreover, following the adoption of the 16th amendment, there have been at least three principal cases in the intergovernmental immunity area saying that either the States could tax income that was related to costs of the Federal Government, or vice versa. They are in my statement, Senator. They deal with salaries; they deal with a sales tax that was on a cost-plus contract where all of that cost was passed directly to the Federal Government. It was held that intergovernmental immunity did not apply.

Basically, what we have come to as a result of these cases is that the tax on the person who contracts with the State, whether it is for services or whether it is for lending money, is not a tax on the State itself. Sure, it can make it more costly, but the Supreme Court has said that that burden is the normal incidence of the organization within the same territory of two governments, each having the tax power.

Therefore, it seems to me that what you are concerned with in this whole area, whether it is general obligation bonds or revenue bonds or arbitrage bonds, the basic question is one of policy: Do you want to do this?

Now, I don't think anyone has ever suggested that it is unconstitutional to allow a deduction or not to allow a deduction for State and local taxes; yet, it is clearly being proposed. It is a question of policy, to accommodate the relations between these two areas of government.

[Mr. Lubick's written testimony follows:]

STATEMENT OF DONALD C. LUBICK
BEFORE
COMMITTEE ON FINANCE, UNITED STATES SENATE
TUESDAY, JUNE 25, 1985

Mr. Chairman and Members of the Committee:

I am pleased to appear before you to comment on the constitutional issue involved in subjecting to the federal income tax the interest paid to a private taxpayer on obligations of a state government or of a locality exercising governmental functions within a state. An examination of the arguments and Supreme Court precedents leaves no reasonable doubt that Congress may under the Sixteenth Amendment tax income that includes such interest, if the tax applies on a nondiscriminatory basis to all comparable income regardless of source.

Congress has indeed included all such income in gross income under Section 61 -- income from whatever source derived -- adopting the language of the enabling constitutional provision (the Sixteenth Amendment), but has gone on to grant an exemption by way of exclusion under Section 103. If the full exemption by way of exclusion is based on no constitutional requirement, as I believe is clear, it can surely be withdrawn in whole, if Congress so chooses, or in part, as Congress has chosen to do for many years in the cases, for example, of industrial revenue bonds, arbitrage bonds and most recently, bearer bonds. Thus everything proposed in the Administration's tax program relating to state and local bonds is constitutional, and indeed the Congress could constitutionally go all the way to tax municipal bond interest in full short of a discriminatory selective tax on such income.

The argument for constitutional immunity is that a tax on the income from state obligations makes it more costly to borrow, because it results in the necessity to pay higher interest. Hence the tax becomes a burden on the source of the interest, namely the payor state. The argument was applied by the Supreme Court in _Collector v. Day_, 11 Wall. 113(1870), holding the United States could not tax the salary of a state judicial officer lest it be a burden on the exercise by the state of its judicial governmental function. It was carried further in _Pollock v. Farmers' Loan & Trust Co._, 157 U.S. 429 (1895), holding unconstitutional an income tax statute applied to income from municipal bonds as impairing the states' borrowing capacity.

Collector v. Day was expressly overruled by the Court in _Graves v. New York ex rel. O'Keefe_, 306 U.S. 466 (1939), where the Court held a state could tax the salary of a federal employee without running afoul of any prohibition because of intergovernmental immunity. _Pollock_ itself was overruled by the Sixteenth Amendment that granted Congress power to tax income "from whatever source derived."

Subsequent cases repudiate the underlying notion of _Pollock_ that a tax on the income derived by private citizens who lend to a state is a tax on the power of that state to borrow.

Metcalf & Eddy v. Mitchell, 269 U.S. 514 (1926) held the United States could tax income derived by an independent contractor from contracts with a state. The Court recognized that the tax increased the costs incurred by the state, since without taxation, the contract price would be less. Since the tax was imposed on income without discrimination as to source, it was held not to be an impairment of the state's governmental function. Including interest in taxed income similarly would make borrowing more costly, but would not be a tax on the state.

Helvering v. Gerhardt, 304 U.S. 405 (1938), upheld a tax by the United States on salaries of state employees and again repudiated the rationale of the *Pollack* case. The Court said "The mere fact that the economic burden of. . .taxes may be passed on to a state government and thus increase to some extent. . .the expense of its operations, infringes no constitutional immunity." In the face of this holding and language, the immunity from taxation based upon *Pollock* cannot stand.

Next, *Alabama v. King & Boozer*, 314 U.S. 1 (1941), upheld a state sales tax on the cost of material used by a contractor in performing a cost plus contract with the United States. The burden fell exclusively on the United States, yet the Court ruled that this did not involve immunity of the Federal government from taxation by a state.

These and a number of other cases are collected in the opinion of Justice Stevens in South Carolina v. Regan, U.S. (1984), which does not involve a decision on substantive merits. The Stevens opinion points out that the income tax on state bond interest is not imposed on the state at all, but only on persons with whom it contracts. Under the test of New York v. United States, 326 U.S. 576 (1946) upholding a United States tax on income of New York from sale of state owned mineral waters, this alone justifies nondiscriminatory taxation. The test of that case requires that the immunity question is not reached until the subject of taxation is state property or the state activity itself.

No one has ever seriously claimed it is a constitutional requirement that the deduction for state and local taxes be allowed. There seem to be some who have expressed the view that alteration of that deduction might impair the exercise of governmental functions. That question is being addressed on grounds of policy, not constitutional immunities. The treatment of interest income from state and local obligations can be addressed only in the same way.

STATEMENT BY LINDSEY MILLER-LERMAN, PARTNER, KUTAK, ROCK & CAMPBELL, OMAHA, NE

Ms. MILLER-LERMAN. Thank you, Mr. Chairman.

I am Lindsey Miller-Lerman. I am a partner in the law firm of Kutak, Rock & Campbell in my home State of Nebraska, and we appreciate the opportunity to address the constitutional aspects of the President's proposal with respect to the proposed withdrawal of the tax exemption for interest on State and local obligations. For convenience I will just refer to this, if I may, as local obligations, and by that I would imply the State and local municipalities, even small issues and IDB's.

This is a narrow topic, the constitutionality of the proposal. The proposals are perhaps somewhat broader than we had at first realized from the economists. We have explored the contours of the President's proposal; specifically we have an example about the zoo, and it looks like the cities are going to have to run the zoos whether or not they like that operation, because otherwise if they have a contract for longer than 1 year with people in the zoo business, the underlying bond obligation having supported the zoo, the tax exemption would be threatened.

There is another aspect of the President's proposals which we have heard about, which is the 1-percent aspect; and that is, if greater than 1 percent of the proceeds of the issue, the local government issue, would be used by a nongovernmental source, the tax-exempt status of the whole issue could be condemned.

So let's say you want to build a new government center. It is going to have a new State house, it is going to have the supreme court of that State, and greater than 1 percent of that space is given to a vendor to run a restaurant. It is a State thing to do to have a State house and a government center; but because greater than 1 percent of the facility would be used by, say, a vendor who runs a restaurant, the whole facility would be jeopardized in terms of its tax-exempt status.

These are very broad proposals. They haven't gone this far, and that is why we are talking about the Constitution today. There is an increase in litigation surrounding the constitutionality of removing the tax-exempt status of municipal obligations, and it is because we are getting to the limits.

The law is, based on the case of *Pollock* decided in 1895, that it is unconstitutional to tax the interest of local and State obligations. Now, with all due respect, that case has never been overruled. I should probably just stop talking and say that's all there is on the subject. But there are a lot of other cases that address tax-exempt issues. There are a lot of other cases that address immunity issues. But the law remains on the basis of the *Pollock* Case that it is unconstitutional to tax interest on State and local obligations.

Now, the issue that was raised by my opposing counsel, if you will, is that in enacting the 16th amendment, which permits the direct income tax, the provisions of *Pollock* were impliedly overruled. But there is a lot of congressional debate surrounding the enactment of the 16th amendment, which shows, in correspondence amongst several Senators including those who sponsored it—one of whom was from Nebraska—that it was the intention of the 16th amendment merely and only to make it clear that the apportionment of taxes was no longer required, but not to overrule *Pollock*.

Senator Long in 1982 entered in the record, on this same subject matter, that the 16th amendment did one small thing: it removed the issue of apportionment of taxes.

Now, why does this apply to constitutional dimensions? Federalism requires that the States and the Federal Government exist. And the States, in order to exist, do the State thing: they raise debt, they issue taxes. If you burden the opportunity of the States to issue debts, you are telling them they cannot survive. You are telling them, "We are going to interfere with your ability to contract with the public in the fashion you choose to incur debt." If it burdens the State and threatens the preservation of the State, it is unconstitutional. This flows from the 10th amendment, which reserves those powers to the State. If a State does an activity which is unique to the State, like issuing debt, it is sacred.

I would be happy to entertain some questions on this topic. This is a very serious matter, because we are getting to the edge of the constitutionality of some of these proposals, and I ask that we not be at all lighthearted about the issues today.

Thank you.

The **Chairman**. Well, this committee would never be lighthearted. [Laughter.]

[Ms. Miller-Lerman's written statement follows:]

STATEMENT OF MS. LINDSEY MILLER-LERMAN
PARTNER, KUTAK ROCK & CAMPBELL
AT THE U.S.SENATE COMMITTEE ON FINANCE
June 25, 1985

Federal Taxation Of The Interest On Municipal Bonds Is Barred By The U.S. Constitution

Mr. Chairman and Members of the Committee:

I am Lindsey Miller-Lerman, a partner in the firm of Kutak Rock & Campbell, a four-city law firm which is prominent in municipal finance. My own experience is that of a trial and appellate advocate in the federal courts. You have asked me whether the proposal in the President's tax simplification proposal to tax the interest on most state and local bonds would be constitutional.

The time available since we received our invitation to testify has not permitted a brief to be prepared. These remarks are but a simple outline of the principal reasons why a tax on the interest on state and local debt would be likely to be held unconstitutional by the Supreme Court of the United States.

The Public Securities Association, the trade association of the municipal bond industry, has estimated that the President's tax simplification proposal would eliminate the tax exemption from about 80% of the tax-exempt new issue volume. It would tax the interest on municipal bonds which both the federal government and the states have considered to be exempt from federal taxation ever since the income tax was first enacted in 1913.

The proposal goes so far that a general obligation bond backed by the full faith and credit of a city or state to finance a public facility, such as a city garbage disposal facility, would be taxable if that facility were managed by a private company under a contract for a period longer than one year. In short, this proposal recognizes virtually no constitutional limit on the lengths to which the federal government may go in taxing the interest on state and local debt obligations.

The exemption from federal taxation of interest from state and local obligations is compelled by the Constitution and case law. This conclusion is dictated by historical precedent interpreting the Constitution, particularly the case of Pollock v. Farmer's Loan & Trust Company, 157 U.S. 429 (1895), the recent Supreme Court case of Garcia v. San Antonio Metropolitan Transit Authority, 105 S.Ct. 1005 (1985), and, to some extent, the pending case of State of South Carolina v. Donald T. Regan, No. 94 Original.

The cases grounded primarily on the Tenth Amendment's reservation of rights to the states present the strongest argument that the taxation of interest on state and local obligations is unconstitutional. In striking down an 1894 tax law which imposed a federal income tax on the interest from municipal bonds, the Supreme Court in Pollock v. Farmer's Loan & Trust Company held that federal taxation of the interest from municipal offerings was unconstitutional.

Pollock has never been overruled. No case law under the 16th Amendment (federal power to levy income tax), under the Commerce Clause, or elsewhere has eroded the vitality of Pollock. Indeed, the Supreme Court's recent decision in Garcia (regarding federal state relations under The Commerce Clause) is not to the contrary.

The fact that the Supreme Court has accepted original jurisdiction over State of South Carolina v. Regan (asserting the unconstitutionality of federally-required registration of tax-exempt bonds) suggests that issues of constitutional significance are implied even in matters which do not involve direct taxation of municipal bonds.

The sovereignty reserved to the states is a matter of constitutional dimensions, Tenth Amendment law, and the historical application of federalism. This constitutional reservation of rights to the states to perform functions for the benefit of the ever-changing concept of "general welfare" is meaningful only when the breadth of the grant and the exercise thereof are not predetermined. The history of Supreme Court decisions is clear and consistent to the effect that to incur debt in a commercially reasonable and competitive fashion such that the proceeds be used for functions thought by the issuer to be in service of the general welfare of that locale is desirable and an activity preserved to the States under the Tenth Amendment and not subject to taxation.

The constitutional arguments in favor of federal tax exemption for interest from state and local obligations are generally based on the Tenth Amendment and its derivative concept, the doctrine of reciprocal intergovernmental tax immunity between the states and the federal government. The latter is a judicially implied doctrine, deriving from the landmark case of McCullough v. The State of Maryland, 17 U.S. (4 Wheat.) 316, (1819), and elaborated in the Pollock case 75 years later, to the effect that the preservation of a workable constitutionally mandated federalism requires that federal and state instrumentalities be largely mutually free from taxation. Otherwise, the federal system is threatened. For, as Justice Marshall observed in McCullough v. The State of Maryland, "the power to tax involves the power to destroy." Id. at584. Or as the Court put it in Pollock: "As the state cannot tax the powers, the operations, or the property of the United States, nor the means which they employ to carry their powers into execution, so it has been held that the United States have no power under the Constitution to tax either the instrumentalities or the property of the state."

The Tenth Amendment basis for tax immunity flows from the explicit constitutional language reserving rights to the States and the case law thereunder. The Tenth Amendment itself provides as follows: "The powers not delegated to the United States by the Constitution, nor prohibited by it to the States, are reserved to the States respectively, or to the people."

Although the concept of state sovereignty has been defined by judicial decisions, these decisions have not impaired, and have frequently reiterated, Pollock's constitutional immunization of municipal debt. For example, in Helvering v. Gerhardt, 304 U.S. 405 (1938), the Court held that the federal government could constitutionally tax the income of employees of the New York Port Authority, because, among other things, a tax on the earned income of the state employees did not inhibit the functions of the bi-state authority. Notwithstanding this finding, the Helvering v. Gerhardt Court confirmed the vitality of Pollock, and reiterated the constitutional basis for exempting interest on local obligations from federal taxation. The Court in Helvering summarized the tax-exempt cases and observed that tax immunity was invariably preserved in those cases where the nature of the functions being performed by the state or on its behalf were thought to be essential to the preservation of state governments, as perceived by the local entities. 304 U.S. at 417-19. In acknowledging that government activities change over time, the Supreme Court observed that:

> With the steady expansion of the activity of state governments into new fields, they have undertaken the performance of functions not known to the states when the Constitution was adopted, and have taken over management of business enterprises once conducted exclusively by private individuals subject to the national taxing power. In a complex society tax burdens laid upon those who directly or indirectly have dealings with the state, tend, to some extent not capable of precise measurement, to be passed on economically and thus to burden the state government itself.

Id. at 416-17. Recognizing that the function of state activities changes over time, the Court suggested that to tax the state in an area which, in its own view, was important and in which it has undertaken to perform some activity would be unconstitutional. A fortiori, to tax an activity which only a state as a state can perform--namely the issuance of its own debt--is unconstitutional.

Since Pollock, the Supreme Court has consistently treated state entitlement to tax immunity on a functional basis. If the tax in question discriminates against the state itself, it would be unconstitutional. E.g., Massachusetts v. United States, 435 U.S. 444 (1978); New York v. United States, 326 U.S. 572 (1946); South Carolina v. United States, 199 U.S. 437 (1905). The recent case of Garcia v. San Antonio does not change this result. In fact, it reinforces it. Garcia rejected the "governmental-proprietary" distinction endorsed by the Court for nine years on the basis of National League of Cities v. Usery, 426 U.S. 833 (1976), under which "governmental" activities might be deemed exempt from federal interference while "proprietary" activities were not.

Thus, the governmental-proprietary dichotomy represented an aberration in the historical continuum of constitutional tax-exemption cases. By the elimination of the governmental-proprietary vocabulary as a result of Garcia, the constitutional law of tax immunity returns to the time honored approach whereby exemption is honored based on factors such as whether a tax discriminates against the States or whether a State qua State is taxed.

Currently, in State of South Carolina v. Regan, the State of South Carolina challenges the constitutionality of §310(b)(1) of The Tax Equity and Fiscal Responsibility Act, Pub.L.No. 97-248, 96 Stat. 596, under which state and local bonds must be registered to qualify for tax exemption under Section 103(a) of the Internal Revenue Code. The State of South Carolina claims the registration requirements are burdensome and that the loss of tax-exemption as a penalty is unconstitutional under Pollock and the Tenth Amendment. The Supreme Court granted leave to file an original Complaint in February, 1984, thus dignifying South Carolina's claims.

Federalism, of course, anticipates the coexistence of federal and state governments. Under our system of federalism, the States are expected to perform duties and the Tenth Amendment reserves to them rights not otherwise delegated to the federal government. Incurring debt for the preservation of the State and to facilitate the conduct of State and local affairs is commonplace, if not inevitable. For the federal government to dictate the terms thereof and possibly condemn the States' opportunity to borrow is constitutionally unacceptable. As Mr. Justice Fuller said in Pollock:

> [To tax the interest on municipal bonds] would operate on the power to borrow before it is exercised, and would have a sensible influence on the contract. . . .[It would be a] tax on the power of the States and their instrumentalities to borrow money and consequently repugnant to the Constitution.

157 U.S. at 586.

Pollock remains good law. A federal tax on the interest paid on state and local bonds would be unconstitutional. In summary, Mr. Chairman and members of the Committee, while lawyers will argue one side and another regarding the constitutionality of taxing the interest paid on state and local bonds, in the end, the Supreme Court--years from now--will decide the issue. If the Court follows the long line of precedents I have mentioned, it will hold such a tax to be unconstitutional, requiring a huge tax refund to municipal bond holders from an already debt-ridden treasury. In the meantime, the states will have been strapped under the terms of their own bonds with paying taxable market rates to investors for decades to come, creating a huge windfall to those investors whose bonds will have been held to be tax exempt.

Is this disruption of our federal system worth the risk? Clearly not. In constitutional matters, expecially those which go to the heart of federalism, the Congress should resolve constitutional doubt in favor of the states and in favor of our constitutional system itself.

The **Chairman**. I take it that you think as a matter of policy it would be bad to tax them, whether or not it is constitutional?

Ms. **Miller-Lerman**. I am truly not addressing that issue.

The **Chairman**. No; I know you are not, so I am curious where your heart is, in addition to your mind in terms of the law.

Ms. **Miller-Lerman**. Well, oddly enough, I litigate cases by trade. I am not a deal lawyer.

The **Chairman**. That is a good answer, a good answer.

The *Pollock* case was when?

Ms. **Miller-Lerman**. 1895, sir.

The **Chairman**. Roughly the same time as *Plessey* v. *Ferguson*?

Ms. **Miller-Lerman**. I believe.

The **Chairman**. Within a year or two? I am trying to remember when *Plessey* was—1897 or 1893, something like that.

Ms. **Miller-Lerman**. I don't know that.

The **Chairman**. It was a case that stood for 50 years, and then the Supreme Court just said, "No, we are wrong. We are going to change that now." You don't think there is any possibility we would do that with *Pollock*?

Ms. **Miller-Lerman**. Well, they have had the opportunity to remark on the vitality of *Pollock*, and every time it comes up, the Supreme Court will have narrowed the tax immunity as to other things, as, for example, in the case where you can tax the salary of a State employee but, as I say, *Pollock* is good in this one sacred area—they can't tax the interest on the State debt.

The **Chairman**. To the best of your knowledge, or, Mr. Lubick, yours, is there a case pending someplace about our levying taxes on income—where you are above the $25,000 or $32,000 level—on Social Security, part of which income may be interest from municipal bonds?

Mr. **Lubick**. I think that issue is a nonissue. That was basically decided in the *Atlas* case. That issue arises because, if you change your investment around, you may subject yourself to tax on Social Security. The *Atlas* case was a tax on life insurance income.

The **Chairman**. All right.

Mr. **Lubick**. The Supreme Court has already held that is constitutional.

Ms. **Miller-Lerman**. I think there is a matter pending in New Jersey with respect to this.

The **Chairman**. Would the Supreme Court's decision, the substance of it in *South Carolina* v. *Regan*, if they were to decide against South Carolina would that be determinative also of the taxation of the bonds, in your judgment, or not? That is a registration question.

Ms. **Miller-Lerman**. Right. That is a challenge for the uninitiated, by the State of South Carolina. There is a TEFRA proposal that would require that the bonds be in registered form; that is, you can kind of track the ownership of them. But that is not my case; so that was kind of a housekeeping aspect.

The **Chairman**. No. And you don't think that would be determinative of the right to tax them?

Ms. **Miller-Lerman**. No, sir, I don't. I think the tricky part about that is, if they don't come out in registered form they become taxable, and that is a heavy penalty for not doing your homework.

The **Chairman**. Senator Long.

Senator **Long**. I just wanted to touch on an issue that Ms. Miller-Lerman raised here, and I think I might do it best by reading this information to the committee.

> The Sixteenth Amendment was taken up in Congress, and the question of taxation of state and local bonds was not discussed. And as later events show, it was not contemplated that the amendment would permit taxation of state and local bond interest. When Charles Evans Hughes, then the Governor of New York, raised the question during the ratification process of whether the Sixteenth Amendment would permit taxation of state and local bond interest, he was assured by Senators Borah and Brown that no such interpretation was possible.

Now, let me just pause to say that the ratification process is part of a legislative process in passing a constitutional amendment. In this case, every effort was made to persuade Charles Evans Hughes, the Governor of New York, that this was not contemplated in any respect whatever, and that the 16th amendment would not do that, that this was not the purpose at all, as Ms. Miller-Lerman explained.

These comments were found in the Congressional Record for February 10, 1910. The record for March 1, 1910 contains similar assurances in the form of a letter from Senator Elihu Root to the New York State senators. Congressional debate on a proposal made during World War I to tax State and local bond interest also shows the congressional view that such a tax would be unconstitutional, notwithstanding the 16th amendment, as does the fact that in 1923 the Congress considered adopting a constitutional amendment to permit taxation of State and local bond interest.

The 1923 proposed amendment passed by the House did not pass the Senate. The precise question of taxing State and local bond interest has not been considered by a Supreme Court since the adoption of the 16th amendment; however, the Supreme Court on several occasions after ratification of the 16th amendment expressed the view that the Federal Government cannot tax State and local bond interest, citing the *Pollock* case as authority.

And may I say that Charles Evans Hughes, having been Governor of New York, then proceeded to move on to be Chief Justice of the Supreme Court. He made every effort to write into those Supreme Court decisions in which he participated, and it was the Order of the Court in some cases, that clearly the 16th amendment did not contemplate taxation of State and local bond interest. In other words, the assurance that Members of Congress gave Charles Evan Hughes as Governor of New York is reflected in those Supreme Court decisions. It could be claimed that that reflection was dictum, but nevertheless it is the view of a living witness who played a part in the ratification process and would have opposed ratification if it had been contended, as it is now contended by some, that the "clear language" of the 16th amendment suggests that this income be taxed.

> On these occasions involving cases on other subjects, the Court has distinguished the special case of bond interest for the questions such as taxibility of Government contractors and employees, pointing out the immunity of the State's borrowing power from Federal taxation.
>
> In the view of the *Pollock* decision, its many citations since the ratification of the 16th amendment, and the legislative history of the amendment and other related issues, it is clear that the tax on State and local bond interest contained in the

Social Security Amendments of 1983 directly contradict the well-established constitutional prohibition.

It was for that reason that Senator D'Amato and I offered an amendment to a subsequent bill to repeal that provision that was passed in the Social Security law. Our proposal passed the Senate by a vote of 63 to 32. It was not accepted in the conference between the Houses, but it reflects that the Senate, having passed such a provision, has had second thoughts about it.

"The Congress should respect constitutional limitations on Federal taxing power and should not impose a tax to try to tax the interest on State and local bonds," because in my judgment it would be unconstitutional, and it would clearly violate the assurances that Congress gave the Governors, starting with Gov. Charles Evans Hughes, that this was not the intent in the passage of the 16th amendment.

There were people around who recalled what the intent was at the time, at least there were for the next 30 or 50 years after the enactment of the 16th amendment. I would hope that those of us who serve today would review what they had in mind and respect it and protect it, because in my judgment—and I believe Ms. Miller-Lerman is contending this—the Federal Government has no business trying to solve its fiscal problem by passing that problem on to the State and local governments. They have enough problems financing themselves, the way it is, without the Federal Government passing what amounts to a tax on State and local governments.

I would hope very much that we would move in the other direction. As far as I'm concerned, as long as I am a member of the Senate I will join with Senator D'Amato or anybody else who is interested in giving Congress a chance to vote on this over and over, because the more they understand the issue, I think, the more reluctance there is going to be to go home and explain to their constituents that they voted for the Federal Government to tax their city, that they voted for the Federal Government to tax their county, and they voted for the Federal Government to tax their State, because that has not been the view of Congress prior to this one provision which I feel we should change.

The CHAIRMAN. Do you want to respond to that question, Mr. Lubick? [Laughter.]

Mr. LUBICK. Well, basically, as far as the so-called "legislative history" is concerned, a lot of it was examined in the opinion of the Attorney General which was reprinted in the Ways and Means Committee volume in 1942. It indicated that indeed there were some letters written, and that there were letters written the other way. And a number of officials at the time felt that the amendment did do so, did authorize the taxation of State and local bond interest. The Attorney and Governor Hughes who later became Chief Justice Hughes did fear that the language was clear—as I think it is. It says "from whatever source derived." It does go on to deal with the apportionment problem, but this language is put in there, and it follows the *Pollock* case. It seems to me it is a direct response to it.

The amendment was rejected in New York, as the Attorney General points out, after Governor Hughes indicated his fears. It was later ratified after Governor Dix, who said that the amendment had the broad interpretation. So at least perhaps one legislature thought it was opting for the broader construction.

But, Senator, I am not recommending as a matter of policy that general obligation bonds interest be made taxable. I do suggest it is a little odd to say that you are going to deny deductions for taxes of State and local governments. That puts a burden on them. It requires them to increase their taxes. It interferes with the way in which they regulate their taxing power for direct spending; yet the borrowing is permitted to maintain this sanctity. It seems to me you have to get into questions of policy, to what extent you want to permit a subsidy or an incentive, as you will. I see a big difference between general obligation bonds which finance the direct governmental expenditures of the State and revenue bonds, which in a sense are illustrations of the State lending its tax exemption to private enterprise. But I don't think they are constitutional questions; I think they are indeed policy questions.

Senator LONG. Might I ask the witness: You said "the attorney general." To what attorney general were you referring?

Mr. LIBICK. This was 1942, Senator Long.

Senator LONG. Who was that? Let's just put it in the record, who it was. Of course, he doesn't have any more standing than Chief Justice Hughes had, but who was he? [Laughter.]

Mr. LUBICK. The opinion was signed by Assistant Attorney General Samuel O. Clark. My recollection is, in 1942, that the Attorney General was Biddle at the time, if I am not mistaken.

Senator LONG. Well, he deserves his name to be in the record somewhere. [Laughter.]

Mr. Lubick, I assume you are up here doing what you can to defeat this proposal, that is for a denial of the deduction of State and local income taxes; because I can't anticipate any different result, if we are to rely on your testimony, that you came up here arguing that we ought also to be taxing the interest on State and municipal general obligation bonds, and that that would be the next thing you will be suggesting to us after we get through saying that you cannot deduct State and local taxes on the income that you made.

Mr. LUBICK. Senator, I testified on the other side, that indeed I thought it was unwise tax policy to finance this entire tax proposal by denying the deduction of State and local bonds. I guess I am glad I am with you on an issue. [Laughter.]

Which is not to say that I would favor the unlimited deduction of State and local taxes; but I think the pain should be spread generally, and I have some recommendations which I will be glad to discuss with you at an appropriate time.

The CHAIRMAN. Senator Grassley?

Senator GRASSLEY. Mr. Chairman, I have no further questions.

The CHAIRMAN. I have no other questions. Thank you very much; it has been a very good panel. It is most helpful to use this format. I appreciate you both taking the time.

Ms. MILLER-LERMAN. Thank you very much.

[Whereupon, at 12:07 p.m., the hearing was concluded.]

[By direction of the chairman the following communications were made a part of the hearing record:]

UNITED STATES SENATE

COMMITTEE ON FINANCE

WRITTEN STATEMENT

OF

GEORGE W. CREGG,SR,CID/CED

ON

TAX-EXEMPT USE OF IDBs

FOR THE

HEARING RECORD OF JUNE 25,1985

INTRODUCTION

The public purpose supporting the use of tax-exempt financing for the encouragement of economic growth is not well understood even by people who have been directly associated with at least one issue. The "benefits" of a new or enlarged business with new construction and new jobs are readily recognized, and so are the advantages of retaining existing jobs with modernized facilities. The trouble in understanding the complex IDB system is that most people assume that there is a "cost" related to every "benefit". This not so.

LET'S LOOK AT WHAT THE EXPERTS THINK

For years the U.S. Treasury has failed to recognize the enormous benefits not only to the Treasury but also to the local State and Local Government tax coffers that can and do result from successful IDB financings. This was pointed out in 1977 by Dr. John A. Andrews and Dr. Dennis R. Murphy of Emory University in their report entitled,"THE INTEREST TAX-EXEMPTION ON INDUSTRIAL DEVELOPMENT BONDS: THE COST TO THE UNITED STATES TREASURY" which was prepared for the American Industrial Development Council (now: American Economic Development Council). The Treasury seems to think that IDBs and other Municipals should all be analyzed in the same manner. Treasury has not recognized the difference. As pointed out in the Emory University report, "they differ substantially, both in the use to which such funds are put and in their net impact on the Treasury", citing a 1966 Treasury report.

The Fall 1981 issue of the "Municipal Finance Journal" reported an analysis of the CBO study indicating similiar errors in determining "Federal revenue loss", resulting in an agreement by the CBO to modify its figures to take into account the additional taxes which economic activity created by IDB financed projects would generate. When we asked a representative of the CBO why they had not done so in the first place, I was told that no one had asked them to do it.

It is well recognized that Dr. Norman Ture estimated in 1980 that the small issue exemption could be substantially increased and still make money for the U.S. Treasury. After leaving as Undersecretary of the Treasury for Economic and Tax Affairs, Dr. Ture prepared a Special Report for our New York State Economic Development Council, Inc. entitled,"INDUSTRIAL REVENUE BONDS: ESTIMATES OF EMPLOYMENT EFFECTS AND SIZE OF BENEFITING COMPANIES" which was dated September 8,1983. In that report Dr. Ture examined the State of New York's IDB program and concluded that the use of tax-exempt financing over a 13 year period "contributed significantly to expansion of total employment". Dr. Ture's report also indicated that "less than 14 percent" of the financings involved Fortune 500 companies, and that "the benefits of tax-exempt financing of businesses are largely confined to small businesses".(A copy of Dr. Ture's 1983 Report is attached hereto and is intended to be a part of this written statement.)

The Massachusetts Industrial Finance Agency in its October 1981 Report on IDBs concluded that 2/3rds of their IDB users would have either cancelled or delayed their expansion programs if IDB financing were not available.

During 1980-81, Nassau and Suffolk Counties of New York State produced a two-county report which indicated IDBs created or retained 14,055 jobs, and generated payrolls of $198,000,000.00, resulting in 396,000,000.00 in Federal tax revenue over a ten year period. In April of 1985, Thomas Conoscenti and Associates, Consulting Economists, prepared the attached objective analysis which is intended to be a part of this written statement as fully as if set forth herein, and is entitled,"ECONOMIC IMPACT ANALYSIS NASSAU AND SUFFOLK COUNTIES INDUSTRIAL DEVELOPMENT AGENCIES INDUSTRIAL DEVELOPMENT BOND FINANCING PROGRAM 1977-1984". It should be carefully noted that this analysis concludes at page 10 thereof, "...the result is a net gain of over $1.2 billion dollars to Federal, State and Local Governments".

CONCLUSION

Alexander Hamilton in the New York Packet, Tuesday, November 27,1787, wrote, "The ability of a country to pay taxes must always be proportioned, in a great degree, to the quantity of money in circulation, and to the celerity with which it circulates. Commerce, contributing to both these objects, must of necessity render the payment of taxes easier, and facilitate the requisite supplies to the treasury."

Should not we as a Nation reflect on the words of Hamilton, and wonder what contemplated projects will grind to a halt and what economic disaster may occur if the Congress destroys the IDB program?

INDUSTRIAL REVENUE BONDS: ESTIMATES OF EMPLOYMENT EFFECTS AND SIZE OF BENEFITTING COMPANIES

by

Norman B. Ture
Economic Consultant

Summary

The use of tax-exempt financing for private capital projects has been confined primarily to small companies and has added significantly to total employment. These conclusions are strongly indicated by data compiled for New York State. Over the thirteen years of the State's industrial revenue bond program, 123.541 jobs were added or saved in companies operating facilities financed by industrial revenue bonds (IRBs).

Support for this finding is provided by data from a survey by the New York Job Development Authority (JDA) of companies undertaking capital projects with tax-exempt second mortgage loans made by JDA. This survey shows that in the 855 responding companies, the actual number of employees at the end of 1982 totaled 75.845, a gain of 21,023 or 38 percent over the 54,822 employees in these companies at the time of their application for JDA loans.

Particularly impressive were the employment gains in companies with JDA loans during the years 1979 through 1982. These four years were marked by poor economic performance nationwide; real GNP see-sawed within a very narrow range from the fourth quarter of 1978 through the last quarter of 1982. But the aggregate employment of companies obtaining JDA loans during these four years increased by 2.154 or 21 percent over the number on the job as of the time the JDA loan applications were made.

All but a handful of companies receiving JDA funding for capital projects were quite small, as measured by number of employees. Only 15 of the 855 reporting firms had more than 500 employees. Four-fifths of the companies had 100 or fewer workers. Similar results are indicated with respect to IRB financing; less than 14 percent of the cases of IRB financing in New York involved Fortune 500 companies over the programs life.

Introduction: The Policy Issues

The increasing volume of IRBs issued during the late 1970s and so far in this decade has generated renewed concern about the tax treatment of these debt instruments. The criticism of IRBs focuses on a number of issues, some of which are of long standing, associated with the tax exemption of interest on general obligation state and local debt issues in general. Prominent among these issues are the alleged inefficiency of tax exemption, the upward pressure on state and local government general obligation debt interest rates, hence on the cost to states and localities for financing government in their respective jurisdictions, the consequent effects in raising interest rates for virtually all debt issues, the loss of tax revenues suffered by the Federal Government, and the violation of the standards of tax fairness, by virtue of the fact that tax-exempts are presumed to be held primarily by upper-bracket individuals and financial institutions. In the case of small-issue IRBs, this list of complaints is elaborated to include the allegation that those instruments fail to serve the objectives sought by the statutes which authorize their tax exemption. Specifically, it is alleged that the incentives for capital formation afforded by exempting the interest on these issues from tax are not confined to appropriate industrial enterprises, that the IRB issues are not limited to financing investments by small businesses, and that the use of these instruments does not result in any increase in total capital formation and employment.

This discussion focuses only on the last two of the issues suggested by the preceding listing of criticisms, i.e., is small-issue IRB financing confined primarily to small companies, and does the use of IRBs contribute to increasing employment?

IRBs and Employment

The use of IRBs reduces the cost of capital to firms on whose behalf the IRBs are issued by reducing an important element in their financing costs. Because bondholders ––– the suppliers of the capital obtained through this financing ––– are exempt from Federal taxes on the interest on the bonds, they are willing to accept a lower yield on any given amount of saving committed to these bonds than if the bond interest were taxable. By the same token, unless one assumes that people are entirely unresponsive to the net-of-tax return they obtain for the use of their saving, the response is both an increase in the proportion of their saving channeled into these investments and an increase in total saving. Because the tax exemption serves to reduce the coupon rate on the obligations, the amount which the companies using the facilities financed by IRBs must pay to provide the revenues to the issuing authorities for the service of the bonds is, obviously, less than if the bonds were taxable. This reduction in financing cost increases the number of investment projects which can meet the companies' minimum rate of return requirements.

For some companies, the availability of IRB financing makes the difference between undertaking a project or foregoing it altogether. In other cases, IRB financing results in a somewhat larger capital project or a greater number of projects than would otherwise be undertaken. In any event, the lower cost of capital afforded by IRB financing results in an increase in the optimum amount of capital firms want to use, leading to an increase in the business demand for capital facilities.

In this context, the assertion often advanced by opponents of IRB tax exemption that the use of IRBs contributes little if anything to increasing aggregate capital formation is without foundation. To assert that business generally would undertake the same volume of capital additions in any given period of time with or without the benefits of such financing is equivalent to asserting that businesses' investment plans are completely insensitive to the cost of capital. Similarly, to assert that IRBs' tax exemption has no effect on the total volume of private saving is equivalent to asserting that people will save the same amount irrespective of how much consumption they must give up for any given return or irrespective of how well rewarded they are for saving.

The increase in capital inputs (resulting from business response to IRB financing) raises the capital:labor ratio, which increases the productivity of labor compared to levels that would otherwise prevail. This increase in productivity increases the demand for labor services and raises real wage rates; higher real wage rates induce increases in the amount of labor services supplied. The increases in the supply of and demand for the services of labor result in gains in the employment level. This higher level of employment brings about an increase in total labor compensation. And the increases in labor and capital inputs in production results in expansion of total output compared to the levels that would otherwise be realized. The higher levels of real output, hence total real income, in turn generate higher levels of both consumption and saving and capital formation.

Critics of IRB tax exemption assert that the use of these instruments contributes little, if anything, to total employment. analogous to their claim that IRBs afford no effective incentive for additional saving and investment. The argument is that the use of IRBs may well result in a shift in jobs from one location or employer to another, but no increase in overall employment results. Hence, it is argued, the policy objective sought by tax exemption of IRBs — to provide net gains in employment — is not served.

No evidence is provided by IRB critics to support their claims that IRBs result in no net increases in capital formation and employment. In view of the fact that without question the use of IRBs reduce the cost of saving and the cost of capital, one would think the burden of proof would rest on IRB critics to show that saving and capital formation are unresponsive to these incentives. Similarly, one would think that the IRB critics would bear the onus for showing that no increases in employment are associated with the additional industrial, commercial, and service facilities which result because IRBs reduce the cost of saving and capital.

Any empirical demonstration of the effectiveness or ineffectiveness of any tax provision in contributing to additional saving, capital formation, and/or employment of course requires showing what these would amount to in the absence of the tax provision. Because there is seldom if ever the opportunity to undertake the kind of controlled social experiment which would be needed for this purpose, providing evidence as to these "what if" conditions is generally not possible. One must rely on other types of information on the basis of which one may draw reasonable inferences.

In this connection, some extremely useful and indicative data are available pertaining to experience in the State of New York with tax-exempt second mortgage loans made by the New York Job Development Authority to companies locating or expanding in New York. Applicants for this financing submit a variety of information to the JDA, including the number of additional jobs which they believe will result from the proposed capital projects to be undertaken with the tax-exempt financing. To be sure, one might well regard the applicant's estimates with some skepticism, in view of their obvious self-serving aspect. But the JDA also compiles information showing the number of employees the applicant firm had at the location for which the tax-exempt financing is sought at the time of the application and the number of employees actually on the job at that location at subsequent reporting dates. Comparison of these employment data provide substantial indication as to the effectiveness of the tax-exempt financing in adding to employment. Although these bond issues are not identical to IRBs, the results they produce must be quite similar to those afforded by IRB financing.

As of December 1982, these employment data were available from 855 companies for whom tax-exempt financing through JDA had been undertaken since the early 1960's. Based on reports received as of September 30, 1982, reporting companies were 80.9 percent of all companies actually obtaining such financing. On this basis, then, about 1,057 companies had actually undertaken projects with the tax-exempt financing.

The 855 responding companies had reported employment of 54.822 as of the time of their loan applications. They projected employment of 82.479 when the projects for which the loan application were filed were to be in operation. As of December 1982, the actual number of employees totaled 75.845. Although this number is 6,634 short of the projected employment level, it represents a gain of 21,023, or 38 percent, over the original 54.822 employees of the applying companies.

In a dynamic business environment, the results of capital formation projects often differ from those anticipated when the project plans are formulated and the financing is undertaken. Changes in the demand for the product(s) in the production of which the new capital is to contribute may result in better performance than expected, reflected in greater gains in employment than originally anticipated. Demand changes, on the other hand, may also lead to disappointing results. The very substantial gains in employment of the companies using the JDA loans, therefore, cannot be ascribed in full to the response to the tax-exempt financing itself. By the same token, neither can the modest shortfall of actual employment from that anticipated when the loans were applied for be construed as measures of the ineffectiveness of the tax-exempt financing. A conservative assessment would be that over the years company growth assisted by the tax-exempt financing had contributed importantly to expansion of employment.

Economic circumstances over the 20 years for which participating companies reported varied widely from recession to rapid growth, with a significant expansion of capacity and output overall. One might, accordingly, interpret the employment gains reported by the companies receiving JDA loses as reflecting the overall economic expansion rather than response to the incentives conveyed by tax-exempt financing.

To sharpen the focus on the likely effects of the tax-exempt financing, consider the results only for JDA loans extended in the years 1979 through 1982. These were years of poor economic performance nationwide. On a fourth quarter to fourth quarter basis, real GNP increased by only 1.4 percent in 1979. fell by 0.8 percent in 1980, rose by 2.0 percent in 1981, and fell by 1.7 percent in 1982. The fourth quarter 1982 real GNP was only 0.8 percent greater than that of the fourth quarter of 1978. In this period, the aggregate employment of companies obtaining JDA loans, as of the time of their application for the loans, was 10.249. Projected employment was 16.555. Actual employment by these firms as of the end of 1982 was 12.403. While the actual employment results fell short of expectations, they nevertheless represented a gain of 2.154 employees, or 21 percent.

The industrial development bond program has been in existence in New York for 13 years. Over this period local industrial development agencies have floated bonds totaling almost $2.7 billion. During the period, 97 agencies issued bonds for 1.271 projects. Industrial facility bonds, valued at $1.3 billion, account for 49 percent of the dollar total.

Pollution-control and commercial facility bonds amount to $536 million and $835 million, respectively. Although employment data of the sort provided the JDA are not available from the district industrial development agencies, estimates of new or saved jobs are provided by the companies operating facilities for which IRB financing was provided. The reported new or saved jobs attributable to IRB financing aggregate 123,541 over the 13-year period ending December 31, 1982.

The industrial development agency data combined with the JDA survey information strongly urge that the use of tax-exempt financing for industrial, commercial, and service businesses has contributed significantly to expansion of total employment. The view that the employment gains of companies whose capital projects are so financed are merely at the expense of other firms rests on an implicit assumption that there is, at any time, some fixed number of jobs which cannot be expanded irrespective of the incentives for doing so. It is, in fact, absurd to assume that each time a company with IRB or JDA financing increased its employment some other companies lost an equal number of workers. Any such assumption has no more credibility than the assumption that when companies obtaining IRB or JDA financing reduced the number of their employees, other companies necessarily increased their employment in equal numbers. To repeat. the reasonable assumption is that significant net employment gains are reflected in the data provided by the New York industrial development agencies and the JDA.

Size of Companies Obtaining IRB Financing

The information reported by companies obtaining IRB or JDA second mortgage financing does not include detailed data about the companies' size. An examination of the list of companies for whose facilities IRB financing was provided shows that less than 14 percent of the cases involved Fortune 500 companies. To be sure, this does not necessarily demonstrate that all of the remaining cases involved very small companies, but it does strongly indicate that the benefits of IRB financing do not go primarily to large companies.

Substantial confirmation for this conclusion is provided by the survey of companies obtaining JDA financing. According to Mr. Michael F. Woods, Director, Industrial Economic Development, Department of Planning and Marketing of the New York Power Authority, the overwhelming proportion of the 1,035 companies obtaining JDA financing through September 1982 are small companies. This is confirmed by the employment data cited above. The 855 companies responding to the JDA questionnaire employed 75,845 persons as of December 1982, an average of 89 employees per firm. The following table presents a distribution of companies receiving JDA financing by numbers of persons employed at the end of 1982.

Distribution of Companies Receiving JDA Funding
by Number of Employees

Number of Employees	Companies Number	Companies Percent of Total
10 or fewer	116	13.6 %
11 to 50	361	42.2
51 to 100	197	23.0
101 to 250	122	14.3
251 to 500	44	5.1
More than 500	15	1.8
Total	855	100.0

Source: New York Job Development Authority

As the table shows, 42.2 percent of the 855 responding companies had from 11 to 50 employees in the reporting month, December 1982. Less than 7 percent of the companies had more than 250 employees at that time. And almost four-fifths of the reporting companies had 100 or fewer employees.

Unless other data sources can be provided to show a contrary result, it is fair to assume that the size distribution of companies obtaining IRB financing is much the same as that of companies with JDA funding. On this assumption, it seems clear that the benefits of tax-exempt financing of businesses are largely confined to small businesses.

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Staat

June 25 I

Illinois Farm
Development Authority
State Fairgrounds, Springfield, Illinois 62706 217-782-5792

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June 25, 1985

Members of the Senate Finance Committee:

I would like to thank you for allowing me to submit my testimony to you.

The Illinois Farm Development Authority (IFDA) is a state bonding authority which is authorized by the State of Illinois to issue federally tax exempt bonds for agriculture and agribusiness. The IFDA has worked strictly with private placement bonds thus far.

Since the IFDA first started approving bonds and loans in December 1982, we have approved 1,709 loan requests for in excess of $102,000,000 (attached is Exhibit I). The average interest rate on these loans has been 8.75%. Of the loans approved, 66 for $9,485,000 have been for Illinois agribusinesses.

The eligibility requirements for the Agribusiness Loan Program are very simple. To be able to qualify, the agribusiness cannot employ more than 100 employees or they could not have grossed more than $2,000,000 based upon their previous years' tax returns. The agribusiness needs to only meet one of these requirements to be eligible.

The IFDA will also not issue more than $1,000,000 in bond requests for any one agribusiness.

The mechanics of the program are quite simple also. The private lender will set his own interest rate and terms on a tax exempt bond he will buy from the IFDA. The lender buys the bond from the IFDA, and the IFDA turns around and loans this money back to the farmer or agribusiness at the exact same interest rate and terms as the tax exempt bond.

After the IFDA makes the loan to the farmer or agribusiness, the IFDA then assigns all the collateral interest we have in the loan back to the lender as collateral on the bond. When the agribusiness or farmer makes a payment on his loan, he makes the payment directly to the bank. That is the bank's payment on their tax exempt bond (see Exhibit II - Program Summary).

The target groups we are attempting to reach with our Agribusiness Loan Program are the small, rural agribusinesses in Illinois that are the bread and butter of our rural economy. By helping smaller agribusinesses expand and develop, we feel we are creating many more new jobs for rural Illinois, and are saving many existing jobs.

The average size loan request through our Agribusiness Loan Program is $143,700. This is not a large request, but for a rural fertilizer dealer or implement dealership, this is a major investment.

Rural agribusinesses have taken a severe beating the last three years because of the farm economy. By giving rural agribusinesses a small incentive to expand or start a new agribusiness, such as a low interest rate loan, this can mean the difference between success and failure for many small agribusinesses.

Lenders who purchase Aggie IDB's for the most part are small rural banks. The average size bank that participates in our programs has deposits of $57,000,000 and is located in a community of 3,200 people. These banks are using Aggie IDB's to bring new agribusiness into their community and to help existing agribusinesses expand.

In 1984, eight Illinois banks purchased 25% of the total bonds which the IFDA issued ($27,500,000.) Of these eight banks, four have not paid any federal income tax for the past two years. These four banks are not extremely profitable and do not need the tax exempt income. They are buying Aggie IDB's as a service to their local farmers and agribusinesses, and are trying to help stimulate their local economy through the IFDA bond programs. These bankers, as well as others who participate in our programs, feel that they are helping to stimulate growth in their local economies through Aggie IDB's.

Aggie IDB's are exempt from federal income tax, which does create a loss in revenue to the federal government. Most issuers of bonds feel that the jobs created through the sale of IDB's much outweigh the loss of revenue to the federal government.

When the IFDA finances the expansion of an existing implement dealership through the Agribusiness Loan Program, this will create construction jobs in the area and permanent jobs after construction. These permanent jobs created will affect the local grocery stores, gas stations, restaurants, schools, banks, etc. These people will all pay both state and federal taxes which increase revenue to both the state and federal governments.

Attached is a study which shows the actual loss in revenue to the federal government caused by all Aggie IDB's issued across the United States to be $5,600,000 annually (See Exhibit III.) This is a very minimal loss when the benefits are taken into consideration.

In Illinois, the effect of Aggie IDBs has had a very positive impact on our rural economy. Lenders tell us that Aggie IDBs have helped to take excess real estate off of the market, sell new machinery and equipment and finance expansions of existing agribusinesses, as well as finance new agribusinesses. Lenders who do not need tax exempt income are purchasing Aggie IDBs to stimulate their local economies because they know they will benefit over the long run.

Also attached is a survey which the IFDA recently had done on the effects of the Young Farmer Program (Aggie IDB) on farmers who had applied for loans in 1984 (see Exhibit IV). This is a very informative report that I think you will find of interest.

Industrial Development Bonds serve a very useful purpose in rural America, and are one of the few opportunities available to rural America today. The sunset of small issue IDBs will have a very negative effect on our rural economy.

Once again - thank you for the opportunity to submit testimony to you.

Sincerely,

Illinois Farm Development Authority

Ronald L Bai

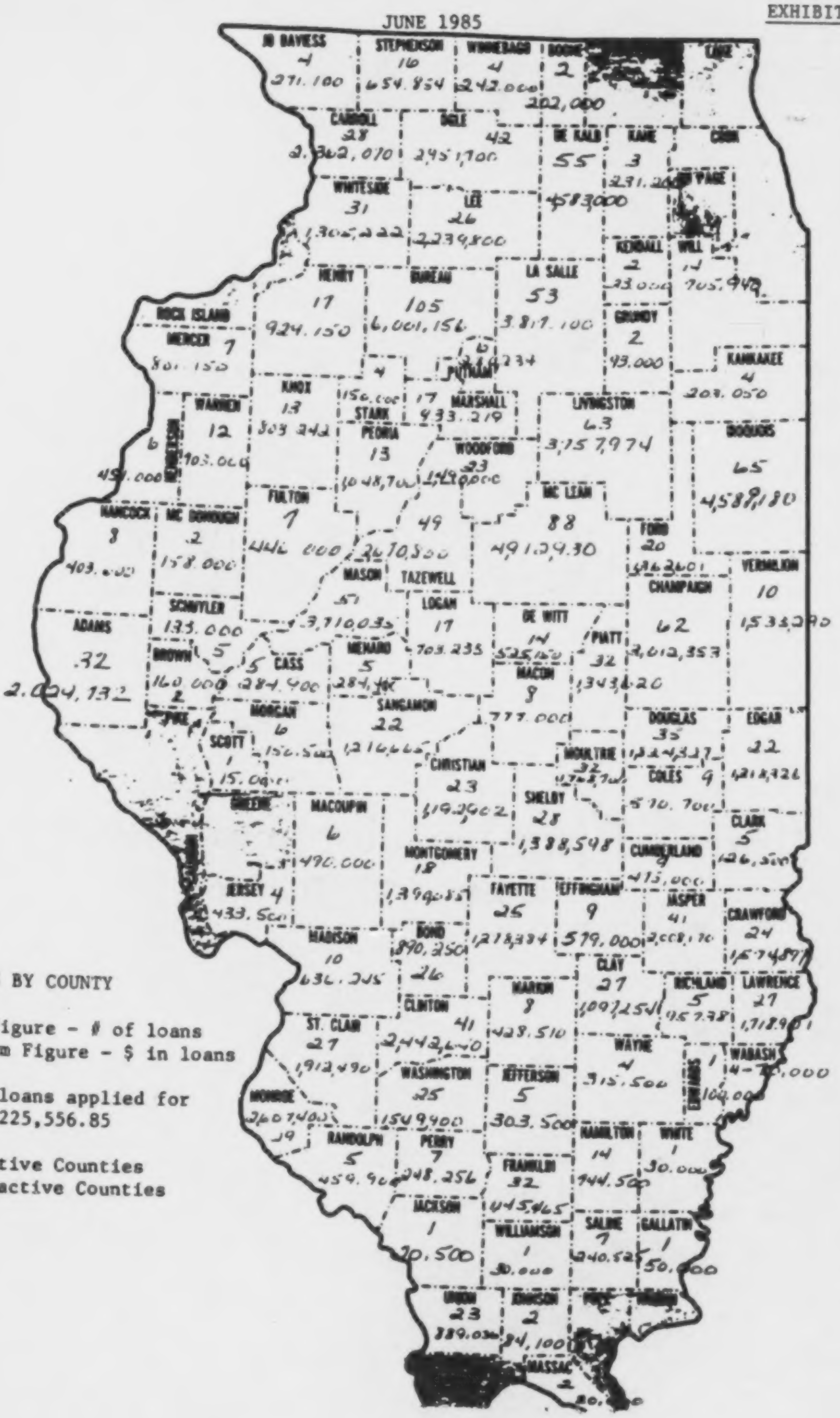
Ronald L. Bailey
Executive Director of the Illinois Farm Development Authority
Chairman of the National Council of State Agriculture Finance Programs

RLB:mo
Attachments

Exhibit is in the offical Committee files.

JUNE 1985

EXHIBIT I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HENRY
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LA SALLE
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GRUNDY
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MC DONOUGH
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FULTON
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446.000
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MC LEAN
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FORD
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862601
VERMILION
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MASON
51
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TAZEWELL
CHAMPAIGN
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SCHUYLER
135.000
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ADAMS
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2.024,132
LOGAN
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DE WITT
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BROWN
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5
CASS
284.400
MENARD
5
284,400
MACON
9
777.000
PIKE
MORGAN
6
150.500
SANGAMON
22
1216,665
DOUGLAS
35
1,224,327
EDGAR
22
1218,326
SCOTT
1
15.000
CHRISTIAN
23
1192962
MOULTRIE
32
COLES
9
510.700
SHELBY
28
1,388,598
CLARK
5
126,500
GREENE
MACOUPIN
6
490.000
MONTGOMERY
18
1,390,85
CUMBERLAND
9
415,000
CALHOUN
JERSEY
4
433.500
FAYETTE
26
1218384
EFFINGHAM
9
579.000
JASPER
41
2,008,170
CRAWFORD
24
1574897
MADISON
10
636.245
BOND
890,250
26
CLAY
27
1097251
RICHLAND
5
957.38
LAWRENCE
27
1,718,901
CLINTON
41
2,442,640
MARION
8
428.510
ST. CLAIR
27
1,912,490
WAYNE
4
315.500
WABASH
1
EDWARDS
4
100.000
WASHINGTON
25
1549900
JEFFERSON
5
303.500
MONROE
2607400
19
RANDOLPH
5
459.906
PERRY
7
248.256
HAMILTON
14
944.500
WHITE
1
30.000
FRANKLIN
32
445,465
JACKSON
1
20.500
WILLIAMSON
1
30.000
SALINE
7
240.527
GALLATIN
1
50.000
UNION
23
389.036
JOHNSON
2
84,100
POPE
HARDIN
MASSAC
2
20.000

LOANS BY COUNTY

Top Figure - # of loans
Bottom Figure - $ in loans

1709 loans applied for
$102,225,556.85

90 Active Counties
12 Inactive Counties

Exhibit II

SEAL OF THE STATE OF ILLINOIS
AUG. 26TH 1818

Illinois Farm Development Authority Loan Programs

ILLINOIS FARM DEVELOPMENT AUTHORITY LOAN PROGRAM SUMMARY

GENERAL

The Illinois General Assembly created the Illinois Farm Development Authority (IFDA) on September 16, 1981 as a means of increasing the availability of loans for the purchase of agricultural land, agricultural improvements, and depreciable personal property to be used for agricultural purposes in Illinois. In 1983, the powers of the IFDA were expanded to include loans to soil or water conservation projects and certain agribusinesses.

The powers of the IFDA are vested in and exercised by a board of seven members who are appointed by the Governor with the consent of the Senate. The current members and their occupations are:

Marjorie Albin	Farmer/Banker, Newman
Ross M. Camp	Farm Manager, Champaign
Robert Nickel	Farmer, Concord
Harold Rice	Farmer, DuQuoin
John Rundquist	Farmer, Butler
Roy Safanda	Farmer/Attorney, Geneva
Patrick Scates	Farmer, Shawneetown

I

LOAN PROGRAM SUMMARY IN BRIEF

The Illinois Farm Development Authority has three loan programs. They are the Beginning Farmer Loan Program, the Soil Conservation Loan Program, and the Agribusiness Loan Program. All three programs use tax-exempt financing to encourage private lenders to make agricultural loans. Beginning Farmer loans are available to qualified individuals for the purchase of certain depreciable agricultural property, agricultural improvements and agricultural land. Soil Conservation loans may be used to finance certain or soil water conservation projects and equipment. Agribusiness loans are available to small Illinois agribusiness operations for the purchase of qualified agribusiness property. (All three programs are described in greater detail below.)

Under each program, the private lender first makes its own loan analysis, determines what collateral and guaranties (if any) are necessary, and sets the interest rate and payment schedule for the loan. Next, the IFDA issues a tax-exempt bond having the same face amount and terms as the proposed loan. The private lender purchases this bond, and the bond proceeds are lent to the Beginning Farmer (Beginning Farmer Loan Program), landowner or operator (Soil Conservation Loan Program) or Agribusiness (Agribusiness Loan Program). Because the interest paid on the bond is exempt from federal income tax, the interest rate on the loan is below standard market rates.

In all cases, the loan and the bond are not obligations of the IFDA or the State of Illinois, but are secured solely by the loan and the collateral required by the private lender.

II

LOAN PROCEDURES

1. **Lenders** – As described above, the IFDA makes its loans available through private lenders. Any federal or State chartered bank, Federal Land Bank, Production Credit Association, Bank for Cooperatives, federal or State chartered savings and loan association or building and loan association, Small Business Investment Company, or any other institution qualified with the State of Illinois to originate and service loans, including, but not limited to, insurance companies, credit unions and mortgage loan companies, may be a lender. "Lender" also includes a wholly owned subsidiary of a manufacturer, seller or distributor of goods or services that makes loans to businesses or individuals.

2. **Participating Lender Letter of Interest** – Lenders interested in the program must complete a Participating Lender Letter of Interest and return it to the IFDA office in Springfield. A lender may receive applications from borrowers after its Letter of Interest has been submitted to and approved by the IFDA.

3. **Application Forms** – Lenders must use the application form provided by the IFDA. Lenders may use their own forms *in addition* to the approved IFDA application form for their own internal loan review purposes, but must see that the IFDA application form is completed in full. Lenders may also use their own financial statement and other forms to document the eligibility of the borrower or his or her ability to make principal and interest payments.

4. **Application Period** – Applications will be processed as received. There is no special time period during or by which applications must be submitted. All applications received by the first Wednesday of each month will generally be considered at the IFDA Board meeting held on the second Wednesday of that month.

5. **Bond Documents** – After the IFDA has approved the loan application and authorized the issuance of the bond, the lender will receive a Bond Documents Package containing the following documents:

(1) Loan Agreement between IFDA and Borrower

(2) Lender Loan Agreement between IFDA and Lender

(3) Closing Certificate of Lender

(4) Certificate of Participant (optional)

(5) Closing Certificate of Borrower

(6) Closing Certificate of IFDA

(7) Arbitrage Certificate

(8) Promissory Note of Borrower to IFDA

(9) Guaranty of Promissory Note (optional)

(10) Specimen Bond

(11) Specimen Bond Opinion

(12) Requisition Forms

Accompanying the Bond Documents Package are instructions relating to the signing of the documents and the making of the loan. Note that all the key terms of the loan, such as interest rate, length of loan, downpayment and repyament schedule are negotiated by the borrower and the lender. The terms of the Loan Agreement, the Promissory Note and the Bond generally conform to the loan terms specified by the borrower and the lender in the Application.

6. **Use of Security Documents** – A separate industrial development bond is issued for each loan, and as a result, there are no aggregated loans for a large bond sale. To facilitate the making of the loan, the Lender Loan Agreement provides that the lender will act as an agent and fiduciary for the IFDA for all purposes in connection with the loan. The principal and interest of the Bond are payable solely out of the revenue derived from the borrower's Promissory Note, which is generally secured by collateral furnished by the borrower. The Bond which is issued by the IFDA and purchased by the lender is a nonrecourse obligation. The principal and the interest on the Bond do not constitute an indebtedness of the IFDA or a charge against its general credit or general fund.

If the lender determines that a Guaranty of the Promissory Note is required, it must use the form of Guaranty included in the Bond Documents Package. In addition, the lender may use any of its own security documents which it may feel necessary and appropriate under particular loan circumstances. Any additional requirements not specifically provided for in the Loan Agreement, such as insurance coverage, can be required.

The IFDA recommends that any security documents required to be delivered in connection with a loan clearly state that they are given as additional security for the indebtedness evidenced by the Promissory Note, the Loan Agreement, the Lender Loan Agreement and the IFDA Bond and to further secure the agreements, covenants and obligations of the Borrower contained in the Loan Agreement. The security documents should run directly between the Borrower and the Lender or the Guarantor and the Lender. The Lender may also wish to add a "cross-default" provision to these documents, making an event of default under the Loan Agreement, the Promissory Note or the Lender Loan Agreement an event of default under the security agreements.

7. **Project Fund and Requisitions** – After all the necessary bond documents have been signed by the borrower and the lender and approved by the IFDA, the IFDA will authorize the lender to make the loan. This is accomplished by the deposit of the purchase price of the Bond in the Project Fund, a separate

non-trusted, non-interest bearing checking account which must be established by the lender with respect to each loan. No Bond proceeds may be used for a non-qualified purpose or by a non-qualified user.

Moneys in the Project Fund may be disbursed only after the borrower files an IFDA Requisition form with the lender in which he or she certifies that the money to be withdrawn will be expended only for the Project approved in the borrower's application. Any moneys which remain in the Project Fund following completion of the Project must be used immediately to prepay the principal of the bond.

8. **Fees** – At the time the loan is made, the IFDA will receive an administrative fee covering the administrative costs connected within the issuance of the Bond and the acquisition of the Promissory Note. The fee, which is equal to 1½% of the amount of the loan, may be financed with loan proceeds, and (except for the portion which is remitted as a $200 application fee) is collected by the lender and remitted to the IFDA at the time the loan is made.

The IFDA bond counsel will review each Bond for legality and exemption of interest from federal income tax. The IFDA will pay its Bond counsel from the administrative fees collected from the borrower by the lender. It should also be noted that any recording of filing fees associated with the loan will be paid by the borrower or lender and not by the IFDA.

9. **Prepayment of Loans** – The Bond Documents and the structure of the financing require any installment payment under the Loan Agreement and Promissory Note to be applied against a like installment payable under the Bond. Under the Loan Agreement and the Lender Loan Agreement, the loan is subject to mandatory prepayment on the happening of certain events and the lender agrees that any such prepayments will be applied to the payment of the Bond. The Loan Agreement requires mandatory prepayment in full with a premium if interest on the Bond becomes subject to federal income taxation as a result of any action (or failure to act) of the borrower which causes interest on the Bond to become taxable. (See discussion of INTERNAL REVENUE SERVICE RESTRICTIONS below). The premium will be equal to the difference between the actual interest payable on the loan up to the date of prepayment and the amount of interest which would have been payable if the lender had charged its normal market rate. In addition, the Loan Agreement provides for optional prepayment without premium (at the discretion of the lender) in the event of damage, destruction or condemnation of all or any part of the Project. The Loan Agreement also provides for prepayment, in whole or in part, without premium at the option of the eligible borrower, on written notice to the lender.

10. **Assumption of Loans and Transfer of Property** – Loans may not be assumed without the prior approval of the IFDA, and then only if the purchaser of the property is an eligible applicant for an IFDA loan. The benefits of the loan made at the tax-free rate from the proceeds of an IFDA bond must remain with the qualified borrower, and no person other than the borrower may obtain the benefits of the IFDA loan.

III

INTERNAL REVENUE SERVICE RESTRICTIONS

As described above, it is the exemption from federal income tax of interest on IFDA bonds which make low interest IFDA loans possible. The Internal Revenue Service has imposed rigid requirements on how bond proceeds may be used in a tax-exempt financing. If any of these rules are ignored by a borrower or a lender in an IFDA financing, there is a substantial danger that interest on the IFDA bond will not be tax exempt. It is the ultimate responsibility of the borrower to see that none of the rules listed below are broken. If a borrower fails to satisfy any Internal Revenue Service requirement, his loan will be subject to mandatory prepayment in full with a premium. Borrowers are required to sign certificates at closing stating that the following rules have been and will be faithfully observed:

1. **IFDA Board Approval.** The IFDA Board must approve the loan *before* the borrower acquires or constructs the property to be financed. *Once the loan has been approved by resolution of the IFDA Board of Directors*, the borrower may use short-term interim or "bridge" financing to acquire the agricultural, agribusiness or conservation property. The terms of the interim financing should specify the purpose for which the loan proceeds are to be used.

2. **Not for Working Capital or Inventory.** IFDA loans *cannot* be used for inventory or to provide working capital. In other words, IFDA loan proceeds cannot be used to purchase feed, seed, fertilizer, fuel, feeder cattle, pigs, and lambs, etc., or to pay salaries or other operating expenses.

3. **No Investments.** IFDA loan proceeds may not be invested by the borrower between the time the loan is funded and the time the loan proceeds are used to purchase agricultural, agribusiness or conservation property.

4. **Qualified Purposes Only.** All of the IFDA loan proceeds must be expended for the purposes stated in the IFDA application as approved.

5. **Used Property Restrictions.** IFDA loan proceeds *can* be used to purchase used property *only* if (i) the used property is purchased in connection with Agricultural Land or (ii) substantial rehabilitation of a loan-financed building will occur.

6. **Non-Agricultural Land.** If land which is not Agricultural Land is purchased (such as for a farm equipment dealership) less that 25 percent of the loan proceeds may be used to purchase that land. "Agricultural Land" is defined as land suitable for use in farming and which is or will be operated as a farm.

7. **Agricultural Land.** IFDA loan proceeds can be used to purchase Agricultural Land only if the borrower is an individual who qualifies as a "First Time Farmer." (See "Beginning Farmer Program, Applicant Eligibility).

8. **Purchase from Related Persons.** IFDA loan proceeds can not be used to purchase property of any type (including machinery, equipment or land) from a Related Person. The IRS states that the following, among others, are deemed to be "Related Persons" of an individual: grandfather, grandmother, father, mother, brother, sister (whether whole or half blood), child, grandchild, or spouse. In addition, a partnership and each of its partners (and their spouses and minor children) are Related Persons as are an S corporation and each of its shareholders (and their spouses and minor children). "Related Person" also includes certain related corporations and partnerships. For example, an applicant (whether an individual or a corporation) could not finance the acquisition of land or property from a corporation (which was not an S corporation) if that applicant, or any of those having the relationships indicated, were to own more than 50% of the stock of the selling corporation. It should be pointed out that the foregoing list is not exclusive. There are certain other entities and individuals that could also be considered "Related Persons." It should also be noted that certain individuals are not "Related Persons." For example, an uncle, aunt, nephew, niece, brother-in-law, or sister-in-law would not be treated as a "Related Person."

The IFDA will review the information supplied in its application to determine whether all Internal Revenue Service requirements have been satisfied. For this reason, it is vital that the application be completed with care.

IV

BEGINNING FARMER PROGRAM

The aim of the Beginning Farmer program is to help new, low net worth farmers get started in farming – and hopefully help keep them in farming. By making available loans with lower-than-market interest rates, the IFDA is helping farmers who will become the backbone of our state.

The sections below outline the basic rules governing (1) what types of property can be financed with a Beginning Farmer loan; (2) who can apply; and (3) loan maximums. In reading these sections, pay special attention to the definitions of key terms such as "Agricultural Land," "Beginning Farmer" and "Net Worth."

Eligible Loan Activities for Beginning Farmer Program

Only the following types of agricultural property can be financed with a Beginning Farmer Loan:

1. **Depreciable Agricultural Property**

(a) **IFDA Definition.** The IFDA regulations define "Depreciable Agricultural Property" to mean personal property suitable for use in farming for which an income tax deduction for depreciation is allowable in computing federal income tax under the Internal Revenue Code of 1954, as amended. Examples include but are not limited to the following: farm machinery, trucks, etc. Feeder livestock, seed, feed, fertilizer and other types of inventory or supplies do not qualify as Depreciable Agricultural Property.

(b) **New Depreciable Agricultural Property.** The IFDA will finance the purchase of any *new* Depreciable Agricultural Property.

(c) **Used Depreciable Agricultural Property.** The IFDA can also finance *used* Depreciable Agricultural Property if it is bought in conjunction with Agricultural Land (within one year of the earlier of (i) the date the Property is acquired or (ii) the date the Bond is issued) and if it will be used in the operation of a farm to be operated on the Agricultural Land being purchased.

2. **Agricultural Improvements**

(a) **IFDA Definition.** The IFDA regulations define "Agricultural Improvements" to mean any improvements, buildings, structures or fixtures suitable for use in farming which are located on Agricultural Land.

(b) **New Agricultural Improvements.** The IFDA will finance the purchase of *new* improvements located on Agricultural Land.

(c) **Used Agricultural Improvements.** The IFDA can also finance *used* Agricultural Improvements – but only in situations in which:

(i) the improvements are bought in conjunction with Agricultural Land (within one year of the earlier of (i) the date the improvement is acquired or (ii) the date the Bond is issued) and will be used in operation of a farm to be operated on the Agricultural Land being purchased; or

(ii) a sufficient amount of qualified rehabilitation expenditures are incurred by the borrower with respect to the Agricultural Improvements within two years from the date of issue of the Bond.

3. **Agricultural Land**

The IFDA regulations define "Agricultural Land" to mean land suitable for use in farming and which is or will be operated as a farm. Any Agricultural Land being financed must be located within the boundaries of the State of Illinois.

Applicant Eligibility for Beginning Farmer Program

1. **"Beginning Farmer" (net worth).** The applicant must be a "Beginning Farmer." Under the IFDA regulations, the term "Beginning Farmer" means an individual who is engaged in farming or wishes to engage in farming and whose net worth (computed under rules prescribed by the IFDA) is "low or moderate." The following rules apply for computing net worth for these purposes:

(a) Low or moderate net worth means an aggregate net worth of an individual and the individual's spouse and children, if any, of less than two hundred fifty thousand dollars ($250,000).

(b) Net worth means total assets minus total liabilities as determined by the lender, in accordance with rules of the Authority and accepted accounting procedures.

(c) Total assets shall include, but not be limited to the following: cash crops or feed on hand; livestock held for sale; breeding stock; marketable bonds and securities; securities (not readily marketable); accounts receivable; notes receivable; cash invested in growing crops; net cash value of life insurance; machinery and equipment, cars and trucks; farm and other real estate including life estates and personal residence; value of beneficial interest in a trust; government payments or grants; any other assets. Total assets shall not include items used for personal, family or household purposes by the applicant, but in no event shall such property be excluded to the extent a deduction for depreciation is allowable for federal income tax purposes. All assets shall be valued at fair market value by the participating lender. Such value shall be what a willing buyer would pay a willing seller in the locality. A deduction of ten percent may be made from fair market value of farm and other real estate.

(d) Total liabilities shall include, but not be limited to the following: accounts payable; notes or other indebtedness owed to any source; taxes; rent; amount owed on real estate contract or real estate mortgages; judgments; accrued interest payable; and other liabilities.

2. **Residency.** The applicant must be a permanent resident of Illinois at the time the completed IFDA loan application is submitted to the lender.

3. **Age.** The applicant must be at least eighteen (18) years of age at the time the completed IFDA loan application is submitted to the lender.

4. **Individuals.** The applicant must be an individual(s). The IFDA cannot loan money to corporations, partnerships, trusts, etc. under the Beginning Farmer Program.

5. **Capital Requirements.** If the loan is sought for the acquisition of Agricultural Land, the applicant may be required to document, to the satisfaction of the lender and the IFDA, that he will have access to adequate working capital, farm equipment, machinery or livestock. If the loan is sought for acquisition of Depreciable Agricultural Property, the applicant should document access to adequate working capital and Agricultural Land.

6. **Active Participation.** If the applicant(s) is purchasing Agricultural Land, he (they) must be the principal user(s) of that land and must use the property being financed in a farming operation in which each applicant actively participates. If a husband and wife jointly apply for a Beginning Farmer loan to finance Agricultural Land, both must actively participate in the farm operation. If husband only applies for a loan for Agricultural Land, he must retain full title to the financed property while the Bond is outstanding.

7. **Ownership of Land.** Any Agricultural Improvements or Depreciable Agricultural Property which are to become a fixture or an integral part of real estate may be financed by the IFDA only if the applicant owns or leases the real estate on which they are to be located.

8. **Prior Ownership of Agricultural Land.** An applicant wishing to finance the purchase of Agricultural Land must *not* have had, prior to the acquisition of the farmland purchased, any direct or indirect ownership interest in farmland in the operation of which he or she materially participated. For purposes of this rule, "ownership or material participation by an individual's spouse or minor child shall be treated as ownership and material participation by the individual."

An exception to the prior ownership rule exists for small farms ("smaller than 15% of the median size farm in the county in which the parcel is located") with a fair market value no greater than $125,000 at the time of prior ownership.

Please note that the applicant, spouse, and minor children can have interests in substantial farmland and still qualify for an IFDA loan as long as they have not materially participated in the operation of the farmland already owned.

Loan Maximums for Beginning Farmer Program

The Illinois Farm Development Act and the Tax Reform Act of 1984 impose limits on the maximum loan amounts under the Beginning Farmer Program. They are:

1. $150,000 for the purchase of Agricultural Land.

2. $250,000 for the purchase of Agricultural Land and used Depreciable Agricultural Property to be used in connection with that Agricultural Land.

V

SOIL CONSERVATION LOAN PROGRAM (SCLP)

The SCLP is intended to facilitate the implementation of permanent soil or water conservation projects and the acquisition of conservation farm equipment for Agricultural Land within the state of Illinois. Soil or water conservation projects and equipment will be funded only if they are part of a conservation plan which has been approved by the local soil or water conservation district.

SCLP Definitions

Below are definitions of key terms necessary to understanding the SCLP:

Landowner or operator means any person, firm, corporation, federal agency, the State of Illinois, or any of its political subdivisions, who shall hold title to or operate Agricultural Land within the boundaries of the State of Illinois.

Agricultural Land means land suitable for use in farming and which is or will be operated as a farm.

Permanent soil and water conservation project means the installation of tiling for drainage, planting of perennial grasses, legumes, shrubs or trees, the establishment of grassed waterways, and the construction of terraces or any other permanent soil and water conservation practice approved by the local soil or water Conservation district.

Conservation farm equipment means any type of no-till or minimum till machinery and equipment which the Soil Conservation District office in the county where the project is located will certify is soil conservation equipment on that particular farm.

Eligible Loan Activities for SCLP

Eligible loan activities consist of financing the following:

1. **Permanent soil or water conservation projects.** The IFDA will finance authorized permanent soil or water conservation projects on Agricultural Land located in the State of Illinois. The component parts of a project can also be financed, including but not limited to, tile for terraced and grassed waterways, inlets for terraces, concrete and steel for erosion control structures, etc. No used components can be financed under the SCLP program.

2. **Conservation farm equipment.** The IFDA will finance the purchase of new no-till or minimum tillage equipment that will be used for reduced tillage or no-till practices on Agricultural Land located in the State of Illinois. The Soil Conservation District office in the county where the project will be used must certify that the equipment is no-till or minimum tillage equipment on that particular farm. Examples of soil conservation equipment could be chisel plows, no-till drills, hay balers, etc.

3. **Conservation district approval.** SCLP loans for permanent soil or water conservation projects or conservation farm equipment will be made only to the owner or operator of a farm located within the State of Illinois for which a conservation plan has been developed and adopted by the local soil or water conservation district.

Applicant Eligibility for SCLP

Basic SCLP applicant eligibility requirements are as follows:

1. **Age.** Applicants who are individuals must be at least eighteen (18) years of age at the time of application. NOTE: Applicants need not be individuals; corporation, partnerships, etc. may apply.

2. **No Residency Requirement.** Applicants who are individuals need not be residents of the State of Illinois. Therefore, even though an individual landowner or operator is not an Illinois resident, he or she may use bond proceeds to construct a soil or water conservation project on land located within the State of Illinois, or to acquire conservation farm equipment that will be used on land located within the State of Illinois.

3. **Net Worth.** Preference will be given to those owners or operators of Agricultural Land who have a lower net worth.

Loan Maximums

There are no upper or lower limits on IFDA loans for permanent soil and water conservation projects or conservation farm equipment.

VI

AGRIBUSINESS LOAN PROGRAM

The Agribusiness Loan Program is designed to encourage the development of small agribusiness operations in Illinois. The IFDA hopes this program will enhance economic growth in Illinois by creating and saving jobs in the rural areas of the state. Of particular importance is the applicable definition of "Agribusiness" and the limitations on the size of the Agribusinesses which qualify for the program.

Definition of "Agribusiness"

"Agribusiness" means any sole proprietorship, limited partnership, copartnership, joint venture, corporation or cooperative which operates or will operate a facility located within the State of Illinois that is related to the processing of agricultural commodities (including, without limitation, the products of acquaculture, hydroponics and silviculture) or the manufacturing, production of construction of agricultural buildings, structures, equipment, implements, and supplies, or any other facilities or processes used in agricultural production. Agribusiness includes but is not limited to the following:

(1) grain handling and processing, including grain storage, drying, treatment, conditioning, milling and packaging:

(2) seed and feed grain development and processing:

(3) fruit and vegetable processing, including preparation, canning and packaging:

(4) processing of livestock and livestock products, dairy products, poultry and poultry products, fish or apiarian products, including slaughter, shearing, collecting, preparation, canning and packaging:

(5) fertilizer and agricultural chemical manufacturing, processing, application and supplying:

(6) farm machinery, equipment and implement manufacturing and supplying:

(7) manufacturing and supplying of agricultural commodity processing machinery and equipment, including machinery and equipment used in slaughter, treatment, handling, collecting, preparation, canning or packaging of agricultural commodities:

(8) farm building and farm structure manufacturing construction and supplying:

(9) construction, manufacturing, implementation, supplying or servicing of irrigation, drainage and soil and water conservation devices or equipment:

(10) fuel processing and development facilities that produce fuel from agricultural commodities or by-products:

(11) facilities and equipment for processing and packaging agricultural commodities specifically for export:

(12) facilities and equipment for forestry product processing and supplying, including sawmilling operations, wood chip operations, timber harvesting operations, and manufacturing of prefabricated buildings, paper, furniture or other goods from forestry products.

Eligible Agribusiness Loan Activities

1. **Depreciable Property (Buildings, Machinery, Equipment).** IFDA Agribusiness Loans may be used to purchase new depreciable property, and, in certain limited circumstances, used depreciable property.

(a) **New depreciable property.** IFDA loan proceeds can be used to purchase or construct new depreciable property which will be used in Illinois by an eligible Agribusiness in connection with its Illinois agribusiness operations. Examples include new grain elevators or sales offices, new trucks or farm machinery (excluding inventory).

(b) **Used depreciable property.** As a general rule, IFDA loan proceeds cannot be used to purchase used property. A limited exception exists for existing buildings and the property located inside or related to such buildings at the time of purchase–but only if substantial rehabilitation expenditures are made within two years of the date the IFDA Bond is issued. For this limited exception to apply, rehabilitation expenditures must be made within the two year period in an amount equal to 15 percent of that portion of IFDA Bond proceeds used to purchase the building and the related equipment.

2. **Agricultural Land.** Agribusiness Program loans may not be used to acquire Agricultural Land. Only individuals may acquire Agricultural Land with IFDA loan proceeds. (See description of "Beginning Farmer" program.)

3. **Non-Agricultural Land.** Less than 25 percent of the proceeds of an IFDA Agribusiness loan may be used to acquire land which is *not* Agricultural Land. For example, if an Agribusiness secures an IFDA loan for $100,000 to construct a farm equipment dealership, less than $25,000 of the loan proceeds may be used to purchase the land on which the dealership will be built. If the cost of the land is $25,000 or more, the Agribusiness must use its own funds to finance the balance of the purchase price.

Applicant Eligibility for Agribusiness Loans

1. The applicant must be an Agribusiness as defined in the Act (see above).

2. The applicant, including all affiliates and subsidiaries, must either (i) have no more than 100 employees at the time of application or (ii) have had a gross income of no more than $2,000,000 for the calendar year preceding the year in which an application is submitted. "Gross income" for this purpose means the amount of gross income properly reportable for federal income tax purposes for the taxable year under the provisions of the Internal Revenue Code of 1954, as amended.

3. The IFDA may waive the requirements of "2" above for any Agribusiness which at the time of application does not operate a facility within the State of Illinois.

Loan Maximum for Agribusiness Loans

No single IFDA Agribusiness Program loan may exceed $1,000,000. No applicant may use more than $150,000 of IFDA loan proceeds to purchase real estate.

VII

TIME TABLES

The IFDA Board of Directors meets on the second Wednesday of each month. At that time the Board approves all eligible loan requests. An application for a loan must be received no later than the first Wednesday of each month (one week prior to the board meeting) to allow sufficient time for processing for the upcoming meeting.

At the following meeting after the application has been approved, the IFDA Board of Directors will approve the bond sale. A public hearing must be held prior to the sale of the bond. A public notice will be published in a newspaper of general circulation in the county where the project is located to advise the public if they wish to attend the public hearing.

Bond Documents Packages will be sent to the lending institutions shortly after the Board has approved the bond sale.

VIII

LENDER POINTS

The tax laws impose many restrictions on IFDA bonds, one of which limits the spread between the actual interest rate the applicant is paying on the Promissory Note (with all points and fees included) and the stated interest rate on the Bond.

Because of these rules, it will not be possible for the lender to charge points to the applicant. Lenders may wish to adjust the applicable interest rate accordingly.

IX

RIGHT TO AUDIT

The IFDA shall have, at any time, the right to audit records of the lender and the borrower relating to a particular bond transaction to insure the bond proceeds were used for qualified purposes by a qualified user.

X

STATE CAP IN ILLINOIS

The Tax Reform Act of 1984 imposes a limit cap on the amount of Industrial Development Bonds (IDB's) which can be issued in Illinois. Bonds issued by the IFDA will fall under this state cap. It is not anticipated that the new state cap will have any significant effect on IFDA loan programs.

XI

IFDA FEES

The IFDA charges an administrative fee on all loans to cover the administrative costs associated with the Bond and the Promissory Note through all programs. This administrative fee equals one and one-half percent of the face amount of that loan, with a minimum fee of $200. The non-refundable $200 application fee required at the time of application is credited against the one and one-half percent administrative fee due at closing.

The Illinois Farm Development is a self sufficient state authority. Its operating expenses and legal fees are all paid from the one and one-half percent administrative fee.

EXHIBIT III

ANALYSIS OF AGRICULTURAL IDB'S

There has been a total of $246,953,512.00 issued in Agricultural Industrial Development Bonds (IDB's) across the United States.

These IDB's are exempt from federal income tax. Private lending institutions purchase these bonds which creates a loss of revenue to the federal government. This loss in revenue is very minimal compared with the benefits agriculture is receiving from them.

Below is the approximate loss of revenue to the federal government which is caused by Agricultural IDB's:

$246,953,512 x 9% (approximate cost of funds for lenders) = $22,225,816.08

$246,953,512 x 14% (assuming this would have been conv. rate charged) = $34,573,491.68

(Total of profits lenders would have received) $12,347,675.60

$12,347,675.60 x 46% (assuming all banks are in a 46% tax bracket) $5,679,930.78

$5,679,930.78 would be the total annual loss of revenue which the federal government is not receiving because of Agricultural IDB's.

In 1984 the Tax Reform Act was enacted which placed many additional restrictions on Agricultural IBD's. In 1984 there were $51,189,697 issued in Agricultural IDB's.

Using the above assumed data (9% - approximate cost of funds for lenders, 14% - assuming this would have been conventional rate charged, and 46% - assuming all banks are in a 46% tax bracket) the federal government lost $1,177,363.03 of federal revenue caused by Agricultural IDB's in 1984.

The Tax Reform Act of 1984's restrictions eliminated many farmers from Agricultural IDB programs who were previously eligible. This is the main reason why so few bonds were issued in 1984.

In January and February 1985, there were $9,581,740 of Agricultural IDB's issued. Assuming that the first two months of 1985 will reflect the demand for Agricultural IDB's in 1985, a total of $57,490,440 would be issued in Agricultural IDB's. Assuming that all the data is constant (as stated previously), Agricultural IDB's will cost the federal government an additional $1,322,280.12 in 1985.

At the current rate of demand for Agricultural IBD's, these bonds will probably cost the federal government approximately $1,325,00/year in loss of revenue.

Assuming that the sunset on Agricultural IDB's goes into effect on December 31, 1986, the total loss of revenue caused by Agricultural IDB's will be $8,109,550/year. This is presuming there is no principal reduction on previously issued bonds (there will be some principal reduction).

Main Point:

The overall loss of revenue to the federal government is very minimal when compared with the benefits Agricultural IDB's are providing to agriculture.

STATE	FROM PROGRAM INCEPTION			JANUARY - DECEMBER 1984			JANUARY - FEBRUARY 1985		
	# OF LOANS CLOSED	$ IN LOANS CLOSED	CONTACT PERSON	# OF BONDS ISSUED	TOTAL $ OF BONDS ISSUED	CONTACT PERSON	# OF BONDS ISSUED	TOTAL $ OF BONDS ISSUED	CONTACT PERSON
ALABAMA		$ 9,000,000		0	$ 0		0	$ 0	
COLORADO	125	$11,000,000	Jim Rubingh	4	$ 500,000	Jim Rubingh	5	$ 1,500,000	Jim Rubingh
ILLINOIS	1,200	$62,521,811	Brenda Leheney	187	$12,364,335	Brenda Leheney	65	$ 3,937,085	Brenda Leheney
INDIANA	71	$ 7,675,000	Greg Clark	43	$ 4,796,000	Greg Clark	4	$ 506,000	Greg Clark
IOWA	397	$31,013,480	Bill Greiner	91	$ 8,619,844	Bill Greiner	12	$ 878,360	Bill Greiner
LOUISIANA	112	$27,163,500	Frank Millican	86	$14,200,000	Frank Millican	8	$ 863,500	Frank Millican
MICHIGAN	46	$ 4,017,987	Don Schaner	26	$ 2,100,500	Don Schaner	(Not available-minimal)		Don Schaner
NEBRASKA	342	$26,436,734	Jim Rieker Morris Reynolds	96	$ 8,609,018	Jim Rieker Morris Reynolds	9	$ 896,795	Jim Rieker Morris Reynolds
NORTH DAKOTA		$19,000,000+	Jeff Weispfenning	0	$ 0	Jeff Weispfenning	2	$ 1,000,000+	Jeff Weispfenning
OKLAHOMA		$47,000,000		0	$ 0		0	$ 0	
SOUTH CAROLINA		$ 625,000		0	$ 0		0	$ 0	
VIRGINIA	18	$ 1,500,000	Jim Kee	0	$ 0	Jim Kee	0	$ 0	Jim Kee
GRAND TOTAL		$246,953,512			$51,189,697			$ 9,581,740	

RESOLUTION OF THE MISSISSIPPI BOARD OF ECONOMIC DEVELOPMENT ENCOURAGING THE UNITED STATES CONGRESS TO MAINTAIN THE USE OF TAX-EXEMPT BONDS FOR PRIVATE JOB CREATING ACTIVITIES.

WHEREAS, the State of Mississippi was the first state in the United States to utilize tax-exempt bonds to provide financing for fixed assets for industry locating or expanding in the State; and

WHEREAS, thousands of jobs and employment opportunities have been made available to Mississippians through such financing since 1936; and

WHEREAS, billions of dollars of capital from outside the State of Mississippi have been brought into the State for financing industrial projects through its tax-exempt financing programs; and

WHEREAS the State of Mississippi is considered a capital deficit state and has a need to attract outside capital for job creation; and

WHEREAS, the United States Congress and the Administration are considering the elimination of tax-exempt financing for private activities; and

WHEREAS, such action will be detrimental to the economic growth and well-being of the State of Mississippi; and

BE IT RESOLVED, That the Mississippi Board of Economic Development urges the Congress of the United States to maintain tax laws that provide for the use of tax-exempt financing for private activities that provide employment opportunities for the citizens of the United States of America.

BE IT FURTHER RESOLVED, That a copy of this Resolution be provided to each member of the Mississippi Congressional delegation and the members of the Ways and Means Committee of the United States House of Representatives and members of the Finance Committee of the United States Senate.

This, the 20th day of June, 1985.

Bill Allain

Governor Bill Allain
CHAIRMAN

Gerald L. McDonald
EXECUTIVE DIRECTOR

ECONOMIC IMPACT ANALYSIS
NASSAU and SUFFOLK COUNTIES
INDUSTRIAL DEVELOPMENT AGENCIES
INDUSTRIAL DEVELOPMENT BOND FINANCING PROGRAM
1977-1984

Peter F. Cohalan, County Executive, Suffolk
Francis T. Purcell, County Executive, Nassau

Prepared for

Nassau County Industrial Development Agency
Suffolk County Industrial Development Agency
April, 1985

Thomas Conoscenti and Associates, Consulting Economists

I SUMMARY and CONCLUSIONS

The primary objective of this analysis was to evaluate the economic impact which (1) Nassau and Suffolk Counties Industrial Development Agencies programs has had on the Long Island economy and,(2) to determine the effect of the program on Federal, State and Local tax revenues.

Based on our analysis, we conclude, that the program has had a net positive economic impact to the regions' economy and, to the tax revenues of the Federal, State and Local Governments.

The following is a summary of our findings:

* Between 1977 and 1984 Over $601.0 Million Dollars of IDB's Were Issued.

* The Average IDB Issued Was 2.4 Million Dollars.

* 42.8% Of The Bonds Issued Were Less Than $1.5 Million.

* 67.0% Of The Bonds Issued Were Issued To Manufacturing Firms And 25.3% Of The Bonds Were Issued To Wholesale or Retail Firms.

* 58,871 Jobs Were Created And Or Retained By The Program Between 1977 And 1984; Over 50% Were Jobs Created.

* Jobs Retained And Or Created Accounted For 4.2% Of The Labor Force In 1984.

* Primary Direct Jobs Generated Over $1.1 Billion Dollars In Wages.

* Secondary Direct Jobs Generated Over $2.2 Billion Dollars In Wages

* Primary Construction Jobs Generated Over $401.5 Mllion Dollars In Wages.

* Secondary Construction Jobs Generated Over $1,244.6 Million Dollars In Wages.

* Total Wages Generated Are Estimated To Be Over $4.9 Billion Dollars

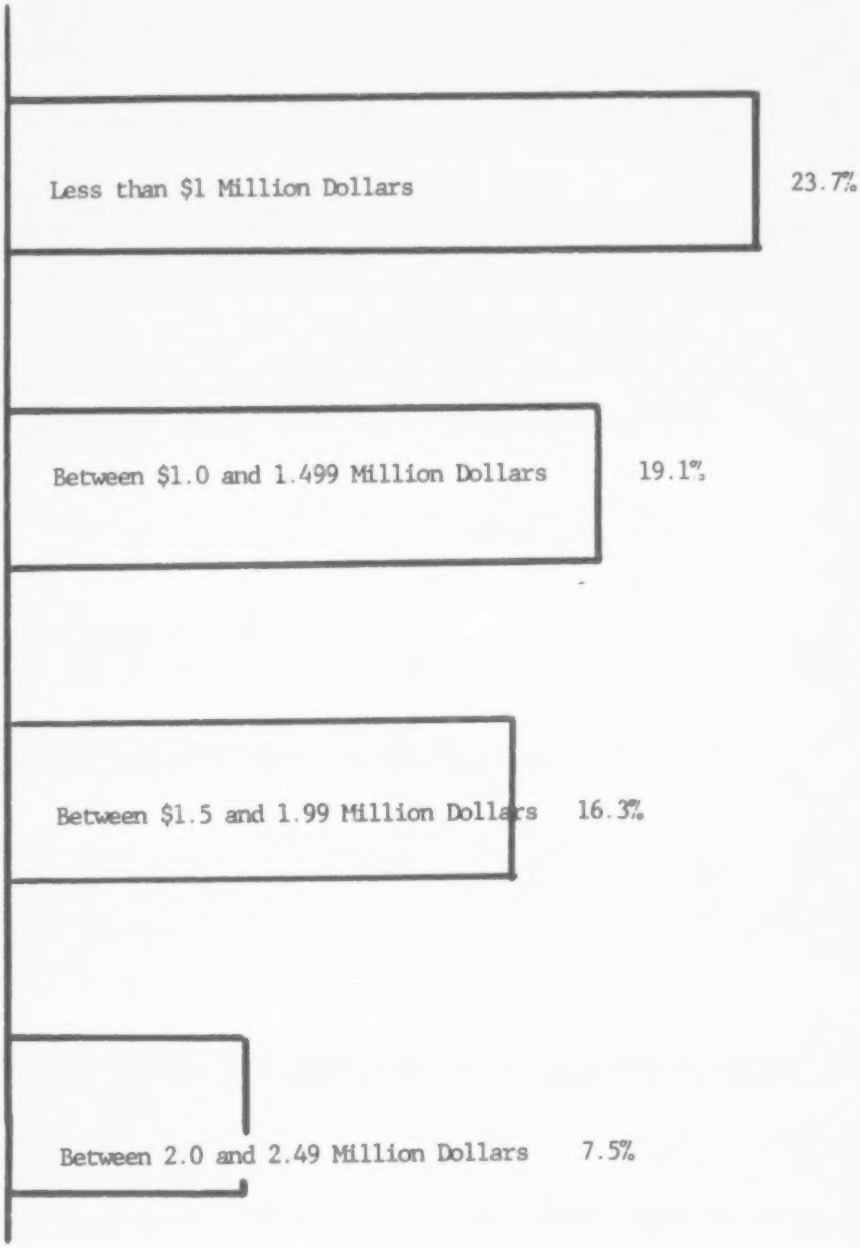
* The Average Wage For Each Job Retained And Or Created Is Over $17,800.

* 10 Million Sq Ft Of New Industrial And Or Commercial Space Was Created.

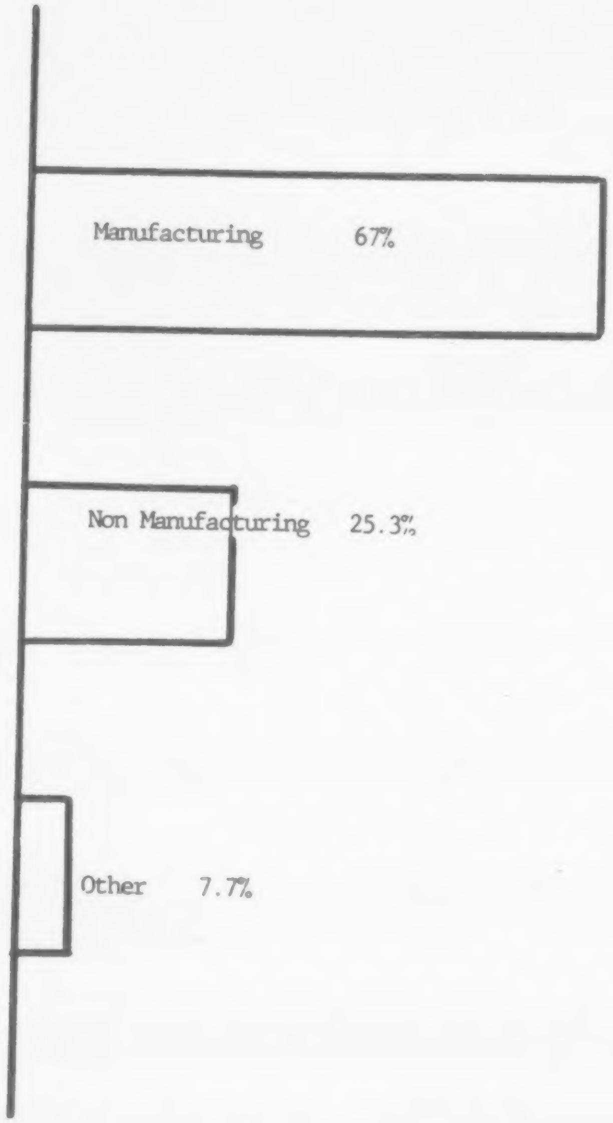
* Total Annual Taxe Revenues Generated: Federal State And Local Governments Is Estimated To Be Over $1.4 Billion Dollars.

Federal Tax Revenues Generated	$991.9 Million Dollars
State Tax Revenues Generated	$353.3 Million Dollars
Local Tax Revenues Generated	$103.6 Million Dollars
Total Taxes Generated	$1.4 Billion Dollars
Net Gains to Government	$1.2 Billion Dollars

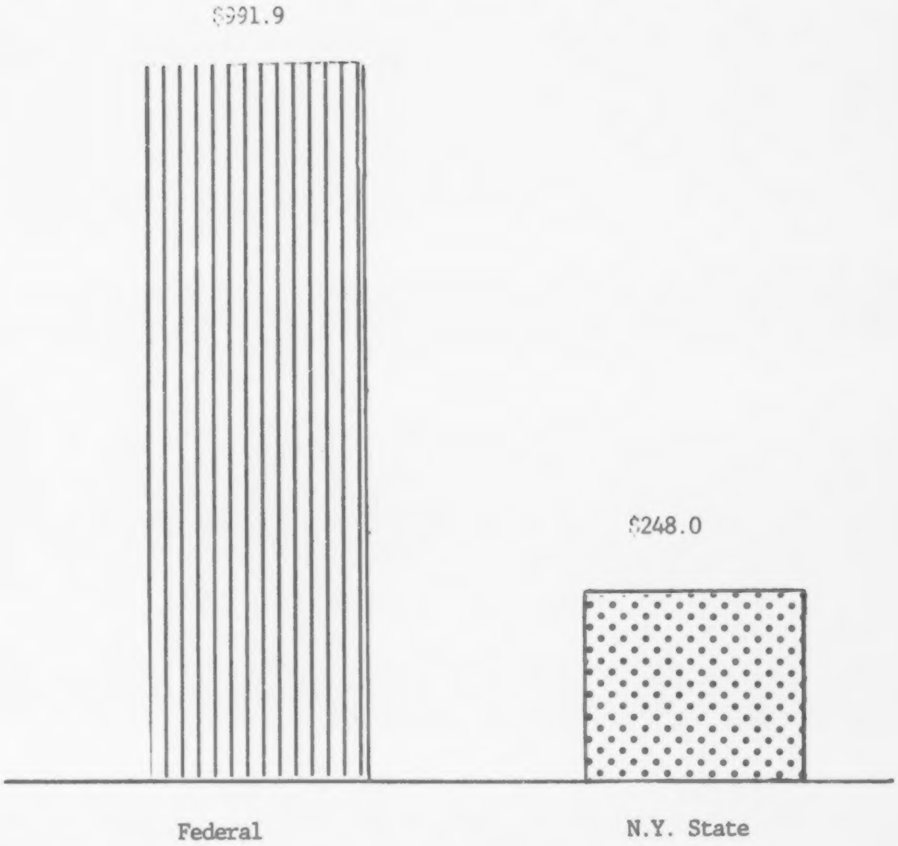
INDUSTRIAL DEVELOPMENT BONDS BY SIZE DISTRIBUTION



DISTRIBUTION OF INDUSTRIAL DEVELOPMENT BONDS by Industry Sector

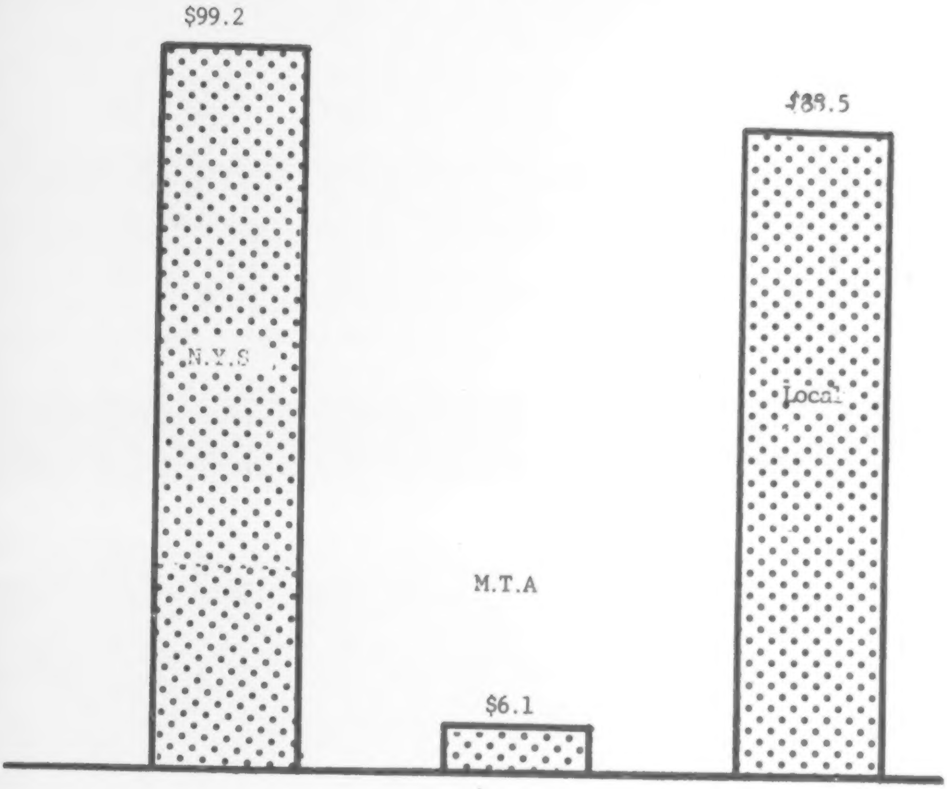


PAYROLL TAXES GENERATED
(Millions Dollars)

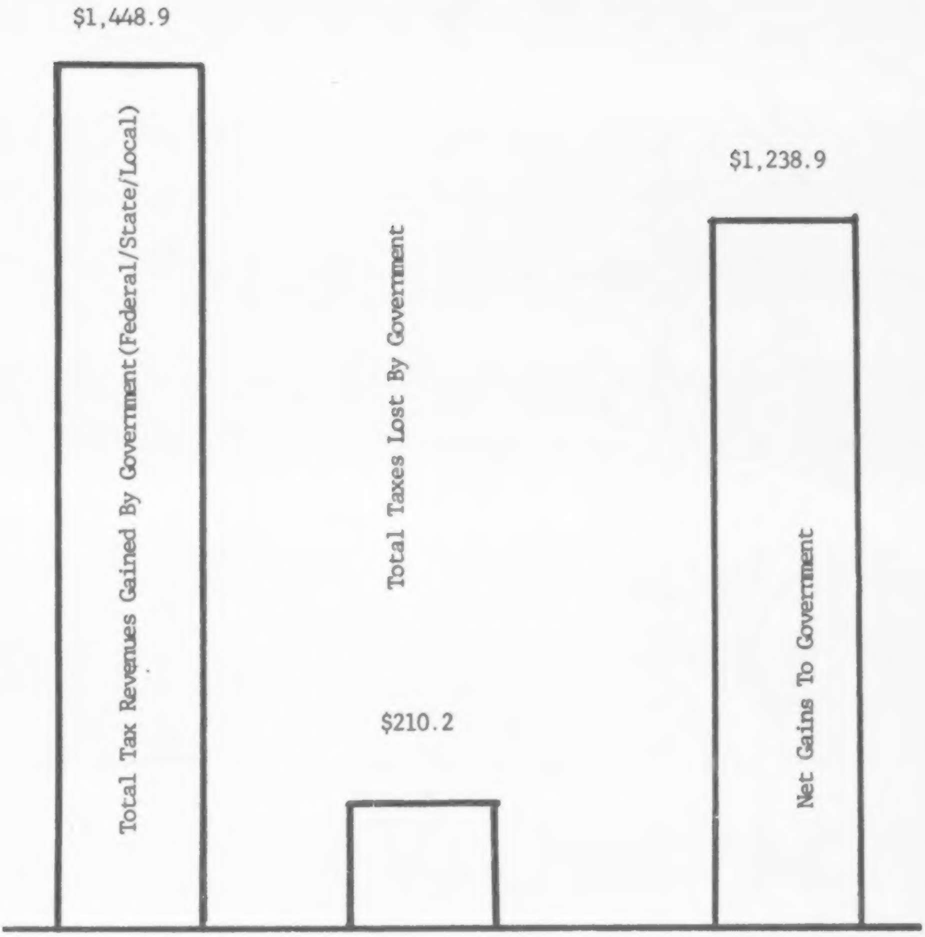


SALES TAXES GENERATED

(Millions $)



NET TAX GAIN TO GOVERNMENT
(Millions $)



II INTRODUCTION:

In 1977 and 1978, under the laws of the State of New York, the counties of Nassau and Suffolk each created an Industrial Development Agency. The objective of each agency is to assist companies in the region and those companies wishing to relocate to the region by promoting, developing, encouraging and assisting in stimulating economic activity which will advance job opportunities in the region. In order to accomplish this task, each agency was authorized to issue tax-exempt bonds to companies for industrial or commercial projects which were found to be eligible under the Act and, which the agency believes to be in the public interest. In addition these projects should strengthen and enhance the economic climate of each county.

The objective of this analysis is to evaluate the degree to which this program has stimulated and strengthen economic activity in the Nassau-Suffolk region and to determine the effect of the program on Federal, State and Local tax revenues.

The following presents our findings.

III IDB FINANCING PROGRAM:SUMMARY OF ACTIVITY

IDB BOND ACTIVITY

Between 1977 and 1984 there were a total of 248 Industrial Development Bonds issued for projects for Long Island companies expansions and or companies who who contemplated relocating to Long Island. The number of Industrial Development Bonds issued by each agency was 124, noting that the Nassau Counties IDA, issued its first IDB in 1979 while the Suffolk Counties IDA issued its first IDB in 1977.

The total dollar amount of bonds issued exceeded $601 million dollars.

Nassau County IDA	$348,445,000*	56.3%
Suffolk County IDA	$262,591,000	43.7%
Total	$601,036,000	100.0%

*Included are taxable bonds issued in the amount of $46.0 Million

The average per bond issue was 2.4 million dollars. Nassau County was higher than Suffolk County; 2.7 million dollars per bond issued in Nassau County and 2.1 million dollars per bond issued in Suffolk County.

Although the average amount of the IDB's issued was 2.4 million dollars, the issues were as small as $250,000 and as large as $32.0 million dollars. However, the interesting observation to make is that 23.7% of the bonds issued were less than 1.0 million dollars and 19.1% of the bonds issued were between 1.0 and 1.5 million dollars. The significance of this is that

42.8% of the bonds issued were issued in small amounts to small businesses in both counties. Small Business is the backbone of the Long Island economy.

EMPLOYMENT AND PAYROLL ACTIVITY

As noted, IDA Bonds are issued for companies who locate or expand their employment activities in the region. One of the criterion used to measure this activity is the number of new jobs created by firms locating on Long Island. In the case of firms contemplating leaving the region, a measurement used is the number of jobs retained. Because companies who re-located to another part of the country weaken the regions economic base by reducing employment by the number of jobs displaced to other regions by this move. For this analysis, jobs retained is the direct result of the IDB program.

During the programs existence a total of 58,871 jobs were retained and or created. The number of jobs retained was 29,362 jobs and 30,509 jobs were created. On balance, for every job retained, one job was created.

The jobs retained and or created were in the manufacturing sector of the economy. Based on a survey of 91 companies for whom IDB's were issued; 67.0% of these companies are in manufacturing, while 25.3% of the firms are in the Non-Manufacturing sectors of the economy.

These jobs as a percent of the Civilian Labor Force, represented 4.2% of the total labor force in 1984.

	Percent of Labor Force
Nassau	4.4%
Suffolk	4.1%
Total	4.2%

These retained and or created jobs generated over 1.1 billion dollars in wages and salaries. Nassau County generated $585.8 million dollars. And Suffolk County generated $483.1 million dollars.

The average payroll per employee was $17,852 in 1984. Ranging from a low of $11,325 to a high of $35,160. In Nassau County the average was $18,678 per employee and in Suffolk County, $16,945.

BUILDING ACTIVITY

Industrial and Commercial space in the Nassau-Suffolk region increased by over 10 million sq feet; 5.9 million sq ft in Nassau County and 4.1 million sq ft in Suffolk County.

These findings are presented in Tables I, II, III

IV IDB FINANCING PROGRAM:ECONOMIC IMPACT ANALYSIS

The previous section summarized the activities of the IDA program between 1977 and 1984. This section will evaluate the economic contribution which the program has had in developing the Long Island economy.

As a starting point for this analysis, it is necessary that we discuss briefly what is meant by an economic impact. In a general way, economic impact refers to what is traditionally called the multiplier or ripple effect. This means that money, either in the form of wages or salaries, expenditures for materials etc., affects the economy in many ways. For example, the money received in wages is spent in the local economy for the purchase of goods and services. This money, received by businessess, is used to pay for various debts incurred, or to make outlays such as inventory stock, advances on orders etc. The recipients, in turn, use the money received to pay their bills to satisfy their debts etc. The money in this way may be spent several times, spreading into different sectors of the economy, each time giving rise to fresh levels of income. This unbroken series of income conversions constitutes what is known as the multiplier or ripple effect. The greater the number of hands through which such money changes, the greater the beneficial effects on the regions economy.

The economic impact resulting from the IDB Financing Program is derived as follows:

Construction Impact:

As noted, the total new plant added to the economic base as a result of the program exceeded 10 million sq feet. However, since the cost of construction is not directly known, it was estimated to be $401.5 million dollars. This was computed by multiplying the number of sq ft of new construction added by the average cost of construction estimated to be $40/sq ft. From this, a secondary impact is estimated to be $1.2 billion dollars. This was calculated, by using the regional construction multiplier of 3.1.(1)

Payroll Impact:

The primary payroll impact resulting from the program amounted to over a billion dollars. Using a multiplier of 2.1, the secondary impact is calculated to be in excess of 2.2 billion dollars.

Total Economic Impact:

Thus the total economic impact, generated by the IDB program, is calculated to contribute over $4.9 billion dollars to the Long Island economy. This is the sum of both the primary and secondary economic effects.

These findings are presented in Table IV

(1) Econometric Model Of Long Island Developed by Thomas Conoscenti

V IDB BOND FINANCING PROGRAM:GOVERNMENTAL IMPACTS

The IDB financing program also impact Federal, State and Local Governments by generating tax revenue in the following ways:

(1) The Federal Government can expect to receive $991.9 million dollars in federal income taxes. This was calculated by applying a 20% marginal tax rate to the total wages paid in 1984. Nassau IDA generated $556.5 million dollars in federal income taxes. Suffolk IDA generated $435.4 million dollars.

(2) State Government can expect to receive 248.0 million dollars in state income taxes. (5% marginal tax rate). In addition, the state will receive $99.2 million dollars in sales tax revenue, generated from expenditures for goods and services. For this analysis, it is assumed that for every dollar of wages paid to each job retained and or created, 50¢ was spent on taxable consumption. Nassau County generated $62.9 million dollars in NYS sales taxes and Suffolk generated $32.6 million dollars State sales taxes. Also, the MTA receives 1/4 of a percent of each taxable sales dollar. In 1984, this generated for the MTA $6.1 million dollars in revenues.

(3) Local Governments (County,Town,School Districts etc.) can expect to receive $103.6 million dollars; $88.5 million dollars in sales tax revenue and 15.1 million dollars in real

property taxes.

The total government tax impact (Federal,State and Local Governments) is estimated to be over $1.4 billion dollars.

These Calculations are presented in Table V, VI

VI IDB FINANCING PROGRAM : COST OF PROGRAM ANALYSIS

The previous sections discussed the total economic impact the program has had in generating new jobs, wages, new construction and tax revenues. However, since these bonds are tax exempt, the arguement has been set forth that assumes that tax revenues will be lost by the federal treasury because of the tax exempt status of these bonds. The question which should be addressed is whether the revenue lost by the treasury, through the tax exemption program, is less that the revenues gained by the IDB financing program.

To answer this question, an assumed taxes lost was estimated by calculating the taxable interest at a fixed rate of 12% over a 15 year period. This taxable interest was estimated to be $280.2 million dollars. The taxable interest was calculated at 50 percent of the total; this was estimated to be $140.1 million dollars. The same calculation was done for the State Treasury using a 25 percent rate. The tax loss for the state was estimated to be $70.1 million dollars. However, when we subtract the tax revenues lost, from the tax revenues gained, the result is a revenue net gain of over $1.2 billion dollars to Federal, State and Local Governments.(Tables VII,VIII)

VII Tables

Note: The data for this study was obtained from the origional application each company filed with the respective agencies and, surveys of the companies activities for the period 1982-1984.

Terms used in this Analysis

IDA = Industrial Development Agency

IDB = Industrial Development Bond

Total Economic Impact = The primary and secondary effects of an initial level of expenditures.

Building Activity = Amount of new sq footage created.

Table I
IDB Financing Program
Summary
1977-1984

	Nassau	Suffolk	Total
Bonds Issued No.	124*	124	248
Amount of Issue(000)	$338,445*	$262,591	$601,036
Average Amount/Issue(000)	$2,729	$2,118	$2,424
Employment			
Retained	19,942	9,420	29,362
Created	11,419	19,090	30,509
Total	31,361	28,510	59,871
Payroll($000)			
Retained	$361,046	$163,674	$ 524,720
Created	$224,705	$319,415	$ 544,120
Total	$585,751	$483,089	$1,068,840
Payroll/Employee			
Retained	$18,105	$17,375	$17,871
Created	$19,678	$16,732	$17,834
Total	$18,678	$16,945	$17,852
New Sq Ft	5,896,111	4,141,790	10,037,901

* Included in this total are two taxable bonds issued in the amount of $46.0 million dollars.

Table II

Percent Distribution of IDB

By Dollar Volume

Million $	Nassau	Suffolk	Total
less 1.0	24.0	23.6	23.7
1.0-1.49	15.2	22.8	19.1
1.5-1.99	14.4	18.1	16.3
2.0-2.49	6.4	8.7	7.5
2.5-2.99	12.8	6.3	9.5
3.0-3.49	6.4	1.6	4.0
3.5-3.99	2.4	3.9	3.2
4.0-4.49	2.4	2.4	2.4
4.5-4.99	2.4	3.2	2.8
5.0-5.49	3.2	5.4	4.3
5.5-5.99	2.4	-	1.2
6.0-6.49	.8	.8	.8
6.5-6.99	1.6	.8	1.2
7.0 or larger	5.6	2.4	4.0
	100.0%	100.0%	100.0%

Table III

Distribution of Companies by Industry Sector

Industry Sector	% Distribution
Manufacturing	
Durable Goods	47.3%
Non Durable Goods	19.7
Total	67.0%
Transportation, Communications and Public Utilities	4.4
Wholesale & Retail	25.3
Finance, Insurance & Real Estate	1.1
Services	2.2
Total	100.0%

Table IV
IDB BOND Financing
Economic Impact Analysis:Wages

	Nassau	Suffolk	Total
Primary Impact			
Construction(Millions)*	$ 235.8	$ 165.7	$ 401.5
Payroll(Millions)	$ 585.8	$ 483.1	$1,068.8
Total	$ 821.6	648.8	$1,470.3
Secondary Impact			
Construction	$ 730.9	$ 513.7	$1,244.6
Payroll	$1,230.2	$1,014.5	$2,244.5
Total	$1,961.1	$1,528.2	$3,489.1
Total Economic Impact	$2,782.8	$2,177.0	$4,896.4

* Construction based on an average of $40/sq ft

K = Multiplier derived from the Econometric Model of Long Island Developed by Thomas Conoscenti and Associates, Consulting Economists

Table V
Governmental Impact Analysis
(Millions $)

	Nassau	Suffolk	Total
Payroll Taxes			
Federal Taxes @ 20% rate			
Primary	164.3	129.8	294.1
Secondary	392.2	305.6	697.8
Total Federal Taxes	556.5	435.4	991.9
State Taxes @ 5% rate			
Primary	41.1	32.4	73.5
Secondary	98.1	76.4	174.5
Total State Taxes	139.1	108.8	248.0
Property Taxes			
Local Taxes @$1.50/ft(1)	$ 8.8	$ 6.3	$ 15.1

(1) Does not reflect any tax abatement program.

Table VI
Sales Taxes Generated
(Millions $)

	Nassau	Suffolk	Total
Primary Effect			
State @4%	$16.4	$13.0	$29.4
MTA @1/4%	1.0	.8	1.8
Local @4%,@3%	16.4	9.7	26.4
Total	$33.5	$23.5	$57.6
Secondary Effect			
State @4%	$39.2	$30.6	$69.8
MTA @1/4%	2.4	1.9	4.3
Local @4%,@3%	39.2	22.9	62.1
Total	$80.8	$55.4	$136.2
Total Effect			
State	55.6	43.6	99.2
MTA	3.4	2.7	6.1
Local	55.6	32.6	88.5
Total Sales Taxes Generated	$114.6	$78.9	$193.8

Assumption: 50% of payroll is taxable consumption.

Table VII
Total Tax Impact

	Nassau	Suffolk	Total
Federal(Millions $)	$556.3	$435.3	$ 991.9
State(Millions $)			
Income Taxes	$139.3	$108.8	$248.0
Sales Taxes	55.6	43.6	99.2
MTA	3.4	2.7	6.1
Total	$224.0	$173.2	$397.2
Long Island Region(Millions $)			
Property Taxes	$ 8.8	$ 6.3	$ 15.1
Sales Taxes	55.6	32.6	88.5
Total	$ 64.4	$ 38.9	$103.6
Total Government Tax Revenues(Millions)	$819.0	$629.4	$1,448.9

Table VIII
Net Tax Gain to Government
(Millions $)

Total Tax Revenues Gained By Government		$ 1,448.9
Total Taxes Lost By Government		
Federal	$140.1 Million Dollars	
State	$ 70.1 Million Dollars	
	Total	$ 210.2
Net Gains To Government		$ 1,238.9

STATEMENT OF
PHILADELPHIA INDUSTRIAL DEVELOPMENT CORPORATION

For

UNITED STATES SENATE
FINANCE COMMITTEE

Hearings Regarding President's Tax
Proposals for Fairness, Growth and Simplicity

July 24, 1985

M. Walter D'Alessio
Chairman
Philadelphia Industrial Development Corporation

Chairman Packwood and Members of the Committee:

My name is M. Walter D'Alessio, I am the Chairman of the Philadelphia Industrial Development Corporation, one of the country's largest municipal issuers of Industrial Development Bonds. I am pleased to have the opportunity to offer my comments which are in opposition to the President's tax proposal to eliminate small issue industrial development bonds.

The Philadelphia Industrial Development Corporation (PIDC), through its affiliate organization, the Philadelphia Authority for Industrial Development, issues all tax-exempt IDBs and mortgages within the City and County of Philadelphia. Since its inception in 1958, PIDC has been involved in over 2,400 transactions, for a total project cost of $2.4 billion, primarily using the incentive of tax-exempt IDB financing. This financing has enabled the creation of 101,227 new jobs and retention of 116,607 jobs for a total job impact of 217,834.

In Philadelphia, small issue IDBs have always been used to achieve "public purposes." In fact, PIDC's criteria for evaluating IDB projects is more stringent in this regard than the Federal regulations. The public benefits from IDBs include: creation of new jobs and retention of existing jobs, which has helped fill the gap left by an exodus of manufacturing jobs over the last two decades; creation of new tax ratables; new construction of plants in City industrial parks on land previously vacant and untaxed; rehabilitation of older and historic buildings in Center City for conversion to office space; revitalization of older industrial neighborhoods; and small business retention and expansion.

These public benefits accrue not only to Philadelphia, but to the State of Pennsylvania and Federal Treasury as well, especially in the form of income and corporate taxes.

We recently completed a report on PIDC's IDB financing from 1981 to 1984, which demonstrates statistically the substantial economic growth at all levels of government resulting from IDB projects. In summary, our report indicated the following:

1. PIDC's annual average issuance of IDBs (1981-1984) was about $215 million. During that time IDBs stimulated $1 billion in investments. For 1985, PIDC's "cap" is $167 million and approved projects already exceed this amount. It is expected that some companies will have to put their expansion plans on hold until additional financing is available in 1986.

2. Since 1981, 33,881 new jobs have been created via IDB assisted projects and approximately 34,000 jobs have been retained, which together amount to 8.6% of the City's 1980 work force. Approximately, 30% of the jobs were manufacturing, 15%

were "industrial" (e.g., industrial suppliers, warehouse distribution and companies providing service to manufacturers), 30% of our projects were in the real estate/finance/insurance sector, (which includes the rehabilitation of older rooming houses and historic buildings into professional and corporate office space); and 15% were in service companies. The trend in Philadelphia's financing reflects the region's shift from manufacturing to service industries, particularly in Center City. (Between 1970 and 1980, Philadelphia lost almost 50% of its manufacturing jobs whereas service jobs grew to be one of the City's largest employment categories.)

3. IDB projects have significantly improved Philadelphia's building stock. From 1980-1984, thirty million square feet of industrial and commerical space was added to the City's tax base via the IDB financed rehabilitation of 660 existing buildings and construction of 135 new buildings, many of which were in PIDC-developed industrial parks.

4. IDB projects are estimated to generate substantial Federal tax revenues. Based upon the City's econometric model, in 1984, an estimated $30.3 million in Federal income taxes was generated just from the new jobs created.

Our report also dispells two popular conceptions about IDB financing. One is that IDBs are used primarily by large companies which don't really "need" the benefit of IDB financing to make their projects financially feasible. On the contrary, PIDC's track record is one of helping mostly small businesses who need the advantage of longer term, lower interest financing in order to implement their capital expansion projects. From 1981-1984 65% of PIDC's IDB financing was $500,000 or under, and 75% was less than $1 million. Moreover, 95% of IDB projects were with companies of fewer than 100 employees. Without the incentive of affordable IDB financing, many of these small businesses would have either left the City or not expanded and eventually decreased, rather than created jobs.

Second, the popular notion is that local governments are not bearing any of the burden of IDB financing and that it is only a Federal incentive. This has not been the case in Philadelphia. In 1984, 30% of PIDC's IDB projects involved a combination of an IDB and a local or state grant or loan. Moreover, 100% of IDB projects received local property tax abatements.

Overall, what PIDC's track record illustrates is that small issue IDBs are accomplishing what Congress intended them to do--stimulate economic development and new capital investment. We have used IDBs to help us attract and retain investment capital as well as to encourage projects which will serve as an anchor for development. While some skeptics assert that IDBs do not produce a "net gain" of employment, we have witnessed the contrary. By lowering the cost of capital, we have been able to lure "anchor" business into marginal neighborhoods or risky projects; diversify our economic base; and help small and family-owned businesses to expand. Many of these projects would not have occurred without IDB financing.

Let me add that contrary to popular notions, IDBs are not used in Pennsylvania to lure companies from one part of the state to another. State law prohibits the use of IDBs by a company which is relocating within the state unless the company is given a "release" from the community it is leaving. Such a release is typically given only when all efforts to keep a company in a particular community have failed.

This brings me to my last point which is the sunset in 1986 on IDBs for non-manufacturing projects and the sunset in 1988 on IDBs used for manufacturing projects. If small issue IDBs are not eliminated in the tax reform proposal, I would urge your consideration of eliminating the sunsets on IDBs. Now that the Deficit Reduction Act of 1984 has placed a volume cap on IDBs and the "abuses" have been eliminated, the program ought to continue at its current level of operation.

If the sunset on non-manufacturing issues in 1986 were to remain in force, PIDC would no longer be able to help two-thirds of the companies it now encourages to remain and expand within Philadelphia. Although 60% of our IDB financing in 1984 was industrial, only half of these companies were strictly manufacturers. The other half were industrial suppliers, warehouse and distribution companies, or companies providing services to manufacturers. All of these companies provide important jobs to residents of Philadelphia.

Moreover, we used IDB financing in the real estate category to revitalize deteriorating areas and reverse the trend toward decay in neighborhoods. Philadelphia is 303 years old and must constantly work to redevelop its older areas in order to continue our renaissance and to maintain the City in a manner that will make us all proud of the birthplace of our nation.

Let me conclude by stating that as direct Federal economic development programs for urban areas are being trimmed back in order to reduce the deficit, it hardly seems fair to eliminate the major incentives cities like Philadelphia have to assist small business growth and expanison and business retention. We feel we have responded to Congress' efforts to ensure that public benefits result from IDBs by instituting policies at the local level which allocate IDBs to those areas and industries most beneficial to Philadelphia economic development.

Once again, I respectfully request that you oppose the elimination of small issue IDBs as proposed in the President's tax proposal and to eliminate the sunsets in 1986 and 1988 on IDBs.

Thank you for the opportunity to share Philadelphia's track record of successful IDB financing with you. Attached to my testimony is a copy of the PIDC report on IDB financing for your review.

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PHILADELPHIA
IDB PROJECT EXAMPLES

As the following examples illustrate, IDBs have been the reason, in any number of transactions, that industrial and commercial companies determined to expand or relocate within Philadelphia.

- Federal Baking Co., maker of the famous Philadelphia soft pretzels, is a family-owned company which used IDBs to increase jobs from 26 to 40.
- Janbridge, Inc. - T-Met Corp., a woman-owned manufacturer of printed circuit boards, is a young company which grew from 10 employees in 1975 to 125 employees and sales over $1 million by 1981. The company decided to increase its productivity by consolidating operations from several locations into one facility, but all the sites available in Philadelphia were too costly. PIDC worked with the company to put together a financing package involving an IDB and CDBG direct loan so the company could remain in Philadelphia and increase employment by 132 new jobs.
- Honor Foods, a Philadelphia-based commercial wholesale/ broker of frozen and refrigerated foods has been located on the waterfront for 35 years. To prevent Philadelphia from losing this company and to enable Honor Foods to expand into a "full service" food wholesaler, PIDC worked with Honor Foods to finance a new facility in one of the City's Enterprise Zones with an IDB, land writedown grant and direct loan. After the move, the company increased its employment from 56 to 91.
- IDBs were used by Consolidated Drake Press Company to purchase its facility and expand at its long time location in a blighted area of the City, and become a catalyst for new economic growth.
- Southwark Metal Manufacturing Co., a Philadelphia-based manufacturer of sheet metal ducts, pipes and fittings since 1949, faced the option of expanding in Philadelphia or relocating. PIDC worked with the company to put together a financing package including an IDB, direct second mortgage loan, local tax abatement and owner equity which enabled the creation of 20 additional jobs, 90% of which were low-moderate income city residents as well as the retention of 140 existing jobs.

STATEMENT OF GEORGE C. WALLACE, GOVERNOR OF ALABAMA

I am most grateful, Mr. Chairman, for this opportunity to speak for the record on behalf of the tax-exempt Industrial Development Bond (IDB) program. I and state and local elected officials elsewhere have watched with great concern as Congress in recent years has repeatedly dealt with the issue of tax-exempt finance. We followed the 1981 Ways and Means Committee hearings on "small issue" Industrial Development Bonds that were held prior to the enactment of the Tax Equity and Fiscal Responsibility Act (TEFRA) in 1982. This legislation purported to eliminate the so called IDB "abuses" that had drawn so much Congressional attention to the tax-exempt finance issue. It also limited the maturity of all "private purpose" financing, set out reporting requirements for all IDB issues, and set in place a December 31, 1986, "sunset" on small issue IDBs in order, presumably, to give Congress a definitive time period in which to conclusively determine the fate of the program.

Less than two years later, Congress again found itself involved in a new round of IDB reform measures included as part of the 1984 Deficit Reduction Act (DEFRA). That legislation resulted in, among other things, the imposition of an annual per capita cap on the volume of "private activity" bonds that may be issued within a state, a limit of $40 million in outstanding small issue IDBs per business, limits on allowable arbitrage income, and further restrictions on IDB abuses, such as those for airplanes, liquor stores, health clubs, etc.

At that juncture, Congress had dealt with the issue of the tax-exempt financing provisions of Section 103 of the Internal Revenue Code twice during the three year period 1982-84. Now, in 1985, before the ink is fully dry on the DEFRA legislation, Congress is once again holding hearings on tax-exempt finance, with a view toward not only prohibiting all types of private activity bonds, but also denying tax-exempt status to those traditional local government revenue or general obligation bonds in which more than one percent of the proceeds are used directly or indirectly by a non-governmental entity.

The point I hope to make in going through this chronology is that, in my humble opinion, the issue of tax-exempt finance has been overworked by the Congress. Congress has heard witness after witness testify on the value of tax-exempt financing to state and local economic development efforts. Numerous small businessmen have come before you to describe how the availability of IDB financing enabled them to develop or expand their businesses and hire employees in situations where they would not otherwise have been able to do so. Even so, it is in this context that I would like to share with you two more "micro economic" examples of the benefits of the availability of tax-exempt Industrial Development Bond financing. The following is an excerpt from a letter written to me by a small town banker who helped arrange IDB issues for a couple of projects that epitomize the small issue IDB program:

> In 1977, I was approached by four gentlemen with a great deal of experience and very little capital who wanted to start a company to manufacture a very specialized type of lifting equipment. We were able to start the company out with minimum financing in a rented 10,000 square foot metal frame building. Within six months, their manufacturing operations had more than outgrown their facility. Inside the building, they were working shoulder to shoulder and had additional work all the way around the building. At that time, they employed approximately 30 people and could not maximize their efficiencies because of their facility limitations.
>
> The growth of this company magnified their capital limitations. While they were profitable and aggressive in promoting their business, the

resulting increase in receivables, inventory and work in progress hindered their ability to put funds into a new plant. Using the Enterprise Industrial Board, we were able to arrange a credit of $320,000 for the company to acquire seven acres of land, a 50,000 square foot building, and adequate manufacturing equipment. Had this credit been arranged as a normal industrial loan, the payments would have strangled this company at a time that cash flow was especially critical. The cost of this facility would have been increased by the sales tax, and the result would be an approximate 50% increase in monthly payments.

As a result of Industrial Development Bond financing, this company is nationally known for their product. This company has employed up to a peak of 250 people. All in all, they are an excellent economic contributor to our community.

We have had a very similar experience with a die casting firm. In 1980, a gentleman who had been with a multi-national corporation in the Northeast started a small die casting business in Enterprise. He had a great deal of experience, but again, very little capital. We helped with the financing of used and rebuilt equipment. His business opened in an old wooden frame garage with about 4,000 square feet. This gentleman and his family worked day and night to establish his business. He, like the other business, was profitable and successful. His business very soon outgrew his facility. All of his cash flow went into improving his equipment, his work process, and accounts receivable. In 1982, we arranged a $300,000 Industrial Bond issue. With these funds, the business acquired land, new equipment, and constructed a 30,000 square foot building specifically designed to facilitate its unique needs. I might add that most of the equipment was purchased from his former employer when he purchased the die casting division of that company and moved it to Enterprise.

With this new facility, sales and income have greatly expanded. Management of this company found that they were non-competitive in bidding on castings that would be plated. It seems that parts would have to be trucked to the Northeast to be plated and then trucked back to the Southeast to the buyer. To overcome this, we committed to an additional Industrial Bond issue of $260,000. These funds were used to buy additional property adjoining the existing facility to build a 10,000 square foot building specifically designed for

> plating and all of the plating equipment. This company expects to begin the use of this plant within 30 days. With this facility being adjacent, parts that would have to be trucked to the Northeast and back can now be moved with a forklift. This addition makes the company extremely competitive for plated castings sold in the Southeast, and also provides a plating facility for the use of other companies, when before, no similar facility was available in our area.
>
> This company now employs up to 100 people at peaks, and it is anticipated that the plating facility will employ up to 20 people. The economic contribution of this company to our community through salaries and purchases is tremendous. The availability of the commercial use of the machine shop required in die making, and the availability of the commercial use of a plating facility make the City of Enterprise a more attractive location to any other industry that might need these resources.

In light of examples such as these and numerous others that Congress has been exposed to over the years, I would think it beyond question that there is in fact some merit to the IDB program. Thus, if this issue is to once more undergo Congressional scrutiny, it seems only reasonable to me that the focus be not on whether to eliminate the program, but rather on how to revise it once and for all in order to preserve it.

I would like to take the liberty here to share with you my personal experience with Industrial Development Bond financing and my views on how I would hope to see it continued. The State of Alabama first authorized the issuance of private purpose Industrial Development Bonds in the late '40s and early '50s with the passage of the Wallace and Cater Acts. I was a member of the Alabama House of Representatives at the time and helped to sponsor and pass these bills. The Cater Act authorized the creation of municipal industrial development boards for the purpose of issuing bonds for industrial development purposes. The Wallace Act authorized the governing bodies of municipalities themselves to issue bonds for these purposes. Under each act, the type of projects authorized were those for the acquisition of land and buildings suitable for use for: (1) Manufacturing, processing, or assembling of any agricultural or manufactured product; (2) Commercial enterprises for storing, warehousing, distributing or selling products of agriculture, mining or industry; (3) Research facilities in connection with any of the foregoing projects; (4) Pollution control facilities.

Alabama was only the second state in the nation to pass legislation authorizing the issuance of private purpose Industrial Development Bonds, with Mississippi being the first to do so in 1936. At the time this legislation was enacted, our state was just beginning to make the difficult transition from an economy based primarily in products of agriculture and natural resources to one with a more stable mix of manufacturing, service industries, government and agriculture.

Our state has come a long way since then, such that, during a six-year period spanning two of my previous terms as Governor (1972-1977), our state led the ten Southeastern states in total industrial capital expenditures. However, our goals insofar as the Industrial Development Bond program is concerned have remained pretty much unchanged. I would be very much in favor of seeing the manufacturing, research and development and pollution control uses of IDBs continued in their current form, and in seeing the more recent commercial, retail, and loans-to-lenders uses of IDBs eliminated or cut back.

In recognition of the fact that certain Northern and Eastern states have had a great deal of success in redeveloping decaying urban areas with IDBs through commercial development projects, I would suggest that, if commercial uses of IDBs are continued in any form, they be specifically targeted to "distressed areas" meeting existing HUD/Urban Development Action Grant (UDAG) eligibility requirements. This would have the practical effect of making commercial use IDBs primarily available in the Northern and Eastern states where their use has historically been most prevalent. It would also be a recognition of and an attempt to deal with the reality that most so-called "abuses" of IDBs are in the commercial and retail area, i.e., shopping centers, office buildings, retail establishments, etc.

In addition, the $150 per capita State cap that was imposed by DEFRA last year should remain in place for two reasons. First, the cap provides an effective way of controlling the total volume of private activity bonds issued and outstanding. Second, and more important, it makes tax-exempt private purpose financing a limited rather than an unlimited resource in each state, and will rightly require each state to develop a system of goals and priorities for use in allocating and administering this resource.

Congress might even want to go as far as to require those jurisdictions issuing IDBs to make some kind of material financial contribution to these projects as well in order for their obligations to qualify for federal tax-exempt treatment. This could be accomplished by either direct grant programs, or by the abatement of state and local taxation, as is currently the practice in Alabama. It should be pointed out, however, that this could be a problem for many states whose enabling statutes or constitutions prohibit such state contributions to private enterprises.

As for the provisions of the President's tax reform plan affecting public-private partnerships for the provision of utilities, sewage disposal and other vital public services, I am confident that the Congressional tax writing committees will ultimately recognize the benefits of these activities. In Alabama, the City of Auburn is a perfect example of how the "privatization" of a waste treatment facility not only addressed the needs of a small community whose sewage capacity was seriously threatened, but did so in a way that saved both the city and the users of the system a great deal of expense. A recent study conducted by Shearson Lehman Brothers, Inc. indicates that the loss of tax-exempt financing for solid waste/resource recovery projects would lead to an approximately 50% increase in user fees to municipal users over a 25 year financing term for projects financed with taxable rather than tax-exempt debt.[1] User fees were also predicted to be substantially higher where municipalities owned and financed these projects with their own tax-exempt general obligations.

This highlights just one of the functions which would be drastically affected by the proposed "one percent rule." Others would be: public power--where a municipally-owned utility finances the construction of an electric generating facility with tax-exempt bonds, and one of its customers is an investor-owned utility that agrees to a 30 year contract for 10% of the facility's output; public safety--where a state issues general obligation bonds for construction of a prison which will be staffed and managed by employees of a non-public entity; resource recovery--where a waste-to-energy plant is financed by a municipal bond, but is to be operated and maintained by employees of a non-governmental entity pursuant to a 10 year management contract, etc., etc.

In conclusion, I would simply like to join with the multitude of state and local elected officials who have written to you and testified before you in asking that this committee do whatever is within its power to save this important tool for local economic development. With federal revenue sharing programs being cut right and left, and with the impending loss of federal deductibility of state and local taxes threatening to freeze local taxes at current levels, cities, counties and states find themselves wondering just how they will meet their future service needs. Tax-exempt private purpose financing could be a viable solution to these problems if allowed to continue.

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[1] "Solid Waste/Resource Recovery Projects: The Impact of the Loss of Tax-Exempt Financing," Shearson Lehman Brothers, Inc., 1985.

And with so much attention being focused on the federal budget and trade deficits, I find it incredible that the use of IDBs is being discouraged by the Congress, rather than being utilized as a tool to bolster our declining U.S. manufacturing capacity. A recent study by Data Resources, Inc. supports the importance of industrial stimulation as a means of reducing the deficit.[2] The first recommendation of that study is as follows:

> The cost of industrial capital should be reduced. Interest rates should be lowered through stronger budget policies. Preferential financing of non-industrial investments should be curtailed. Easier access to long-term capital debt for long-lived investments should be sought.

My experience with the Industrial Development Bond program is that it has played a vital role in accomplishing these goals in Alabama for the last 35 years. I am sure that it can be just as important to the future of my state. The governors of Alaska, New Mexico, Hawaii, Oregon, Wyoming, Montana, Nevada, Idaho, South Dakota, Nebraska, and Washington feel the same, as reflected in the attached letter from George Ariyoshi, Chairman of the Western Governor's Association to Dan Rostenkowski, Chairman of the House Ways and Means Committee. The nine members of the Alabama Congressional Delegation also agree, as reflected by their letter to Treasury Secretary James Baker, also attached. I ask that these letters be included with my statement as part of the official record of this hearing, and I sincerely thank you for this opportunity to share my feelings with this Committee.

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[2] "The DRI Report on Manufacturing Industries," Data Resources, Inc., 1983.

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May 7, 1985

The Honorable Dan Rostenkowski, Chairman
Committee on Ways and Means
1102 Longworth House Office Building
Washington, D. C. 20515

Dear Representative Rostenkowski:

The governors of the 11 western states have reviewed the November 1984 Treasury Department Report to the President on Tax Reform. We support the objective of a tax system which is simpler, fairer, and more economically efficient. The Western Governors' Association (WGA) would like to call to your attention, however, one recommendation in the report which will have adverse consequences in the western states.

We strongly oppose the Treasury Report recommendation to eliminate various tax-exempt bonds issued by state and local governments. The Treasury Department ignores the important public purpose served by these bonds in its mischaracterization of such financing as private purpose bonds. This recommendation eliminates student loan bonds, mortgage subsidy bonds, veterans' mortgage bonds, tax-exempt entity bonds, and industrial development bonds, including agricultural bonds.

The last Congress considered the question of abuses of tax exempt bonds by certain issuers, and placed annual cap requirements on the issuance of industrial development bonds and veterans' mortgage bonds as well as reauthorizing mortgage subsidy bonds in the Deficit Reduction Act of 1984. Neither the Treasury Department nor the Congress recommended such a radical proposal of elimination of these important tax exempt bond programs. All of the bond programs recommended for elimination by the Treasury Department serve important public purposes in those western states that have such programs. We believe that the states are entitled to a stable tax environment in the area of tax exempt bonds so that we are able to plan economic and social development in a responsible manner. As a former governor, you are aware that constant federal legislative change--even the threat of such change--makes the job of governance that much more difficult.

This Treasury Department proposal is also especially untimely in view of other proposals which recommend the transfer of responsibilities for various federal programs to the states. It has been estimated by

Member Governors
Alaska
Bill Sheffield
Arizona
Bruce Babbitt
California
George Deukmejian
Guam
Ricardo Bordallo
Nevada
[illegible] (Chrmn.)
Montana
Ted Schwinden
Nebraska
Robert Kerrey
New Mexico
Toney Anaya
North Dakota
George A. Sinner
Oregon
Victor G. Atiyeh
South Dakota
William J. Janklow
Washington
W. Booth Gardner
Wyoming
Ed Herschler

the Public Securities Association that the Treasury proposal would eliminate the tax-exempt status of 62 percent of all tax-exempt bonds issued in 1983 by state and local governments. This involves such projects as airports, ports, water supply facilities, electric generating facilities, resource recovery plants, pollution control facilities, health care facilities, low income housing, loans for the purchase of agricultural land and equipment, and certain commercial and industrial projects of economic benefit to local communities. Many of these projects would not be undertaken without tax-exempt financing. Enactment of the proposal would result in citizen demand for direct federal assistance for these projects and for job opportunities.

For the reasons outlined above, the governors of the states of Alaska, New Mexico, Hawaii, Oregon, Wyoming, Montana, Nevada, Idaho, South Dakota, Nebraska, and Washington urge you to reject the recommendation on tax-exempt bonds as you make final decisions on your own simplification plan.

Thank you for your consideration of this important matter.

Sincerely,

George R. Ariyoshi
Chairman

STROM THURMOND, SOUTH CAROLINA, CHAIRMAN

CHARLES McC. MATHIAS, Jr., MARYLAND
PAUL LAXALT, NEVADA
ORRIN G. HATCH, UTAH
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DENNIS W. SHEDD, CHIEF COUNSEL AND STAFF DIRECTOR
DEBORAH K. OWEN, GENERAL COUNSEL
DEBORAH G. BERNSTEIN, CHIEF CLERK
MARK H. GITENSTEIN, MINORITY CHIEF COUNSEL

United States Senate
COMMITTEE ON THE JUDICIARY
WASHINGTON, DC 20510

May 24, 1985

The Honorable James Baker
Secretary of the Treasury
U.S. Department of the Treasury
Washington, D.C. 20220

Dear Mr. Secretary:

Over the years the Industrial Development Bond (IDB) program has been one of the most important financing options available to small business in America and in Alabama. By making necessary capital both affordable and available, IDB's have created many new jobs, allowed small businesses to thrive and expand, and generated substantial additional federal revenue by increasing both corporate profits and payrolls.

The Treasury Department's November 1984 tax reform proposals, as currently written, would effectively dismember this program. It has also been reported that the final Treasury proposal, which will be released shortly, possesses these same severe limitations.

While we hope to be able to support whatever tax reform proposal is ultimately developed, the IDB program is critical to the economic development of the State of Alabama. Therefore, it is crucial that these provisions be carefully examined and either removed or modified considerably. We urge you to work with us and the Governor of Alabama to come up with an acceptable alternative that will ensure continued growth for both Alabama and the Nation.

We are sure that you agree that tax reform and economic growth must go hand in hand. We stand ready to assist in that endeavor.

Sincerely,

Howell Heflin
HOWELL HEFLIN, U.S.S.

Jeremiah Denton
JEREMIAH DENTON, U.S.S.

Tom Bevill
TOM BEVILL

Bill Dickinson
WILLIAM DICKINSON

Bill Nichols
BILL NICHOLS

Ronnie G. Flippo
RONNIE FLIPPO

Richard Shelby
RICHARD SHELBY

Ben Erdreich
BEN ERDREICH

Sonny Callahan
SONNY CALLAHAN